

# Internal Revenue bulletin

**Bulletin No. 2001-4**  
**January 22, 2001**

## **HIGHLIGHTS OF THIS ISSUE**

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### **INCOME TAX**

#### **T.D. 8915, page 359.**

Temporary regulations under section 444 of the Code relate to the election of a taxable year other than the required taxable year. The regulations provide that solely with respect to an S corporation shareholder, an electing small business trust (ESBT) and a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) are not deferral entities for purposes of section 1.444-2T.

#### **T.D. 8916, page 360.**

Final regulations under section 864 of the Code provide guidance on the treatment of section 936 corporations for purposes of allocating expenses in order to calculate the alternative minimum tax foreign tax credit. Final regulations under section 904(d) relate to the application of the foreign tax credit separate categories, including the application of the look-through rules under section 904(d)(3).

#### **T.D. 8918, page 372.**

#### **REG-107176-00, page 428.**

Temporary and proposed regulations relate to the deposit of federal taxes pursuant to section 6302 of the Code.

#### **REG-104683-00, page 407.**

Proposed regulations under section 902 of the Code provide that multi-year pooling of earnings and taxes will stop when a foreign corporation ceases to have a 10-percent domestic corporate shareholder. These regulations provide that the active rents and royalties exception from passive income treatment is no longer limited to payments from unrelated payors. The proposed regulations also include other clarifications regarding the application of section 904(d), guidance on the application of section 904(b), and guidance

regarding section 904(j). A public hearing is scheduled for April 26, 2001.

#### **REG-106702-00, page 424.**

Proposed regulations under section 705 of the Code provide guidance for making basis adjustments necessary to coordinate sections 705 and 1032 of the Code in situations in which a corporation acquires an interest in a partnership that holds stock in that corporation. A public hearing is scheduled for May 3, 2001.

#### **REG-251701-96, page 396.**

Proposed regulations under sections 641 and 1361 of the Code relate to the taxation of electing small business trusts (ESBTs). A public hearing is scheduled for April 25, 2001.

### **EMPLOYEE PLANS**

#### **Notice 2001-9, page 375.**

This notice provides relief from the application of the Code's nondiscrimination requirements for certain governmental and church plans. Notices 98-39 and 99-40 modified.

### **ADMINISTRATIVE**

#### **Notice 2001-7, page 374.**

**Information returns; payments to attorneys.** The Service intends to further delay the effective date of the regulations proposed under section 6045(f) of the Code (relating to the reporting of payments of gross proceeds to attorneys). Under this extension, the rules in section 1.6045-5 will apply to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the Federal Register. Notice 99-53 modified and superseded.

(Continued on the next page)

Finding Lists begin on page ii.



Department of the Treasury  
Internal Revenue Service

**Notice 2001-8, page 374.**

**Information returns; discharge of indebtedness.** The suspension of penalties under sections 6721 and 6722 of the Code provided by Notice 2000-22, 2000-16 I.R.B. 902, for certain organizations newly subject to section 6050P is being extended. Penalties will not be imposed on such organizations for failure to file information returns under section 6050P for any discharge of indebtedness that occurs prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued. Notice 2000-22 modified and superseded.

**Rev. Proc. 2001-16, page 376.**

Publication 1245 (Rev. 1-2001) provides specifications for the filing of Forms W-4, *Employee's Withholding Allowance Certificate*, magnetically or electronically. Rev. Proc. 99-47 superseded.

**Announcement 2001-10, page 431.**

This document contains a notice of public hearing on proposed regulations (REG-105316-98, 2000-27 I.R.B. 98), regarding reporting for payments of qualified tuition and payments of interest on qualified education loans and magnetic media filing requirements for information returns. The hearing is scheduled for February 13, 2001.

**Announcement 2001-11, page 432.**

This document withdraws the notice of proposed rulemaking (REG-116733-98, 1999-36 I.R.B. 392) relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition.

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

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## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 444.—Election of Taxable Year Other Than Required Taxable Year

26 CFR 1.444-4T: Tiered structure (temporary).

T.D. 8915

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Tiered Structures-Electing Small Business Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

**SUMMARY:** This document contains temporary regulations amending the temporary regulations under section 444 of the Internal Revenue Code (Code) relating to the election of a taxable year other than the required taxable year. The temporary regulations provide that solely with respect to an S corporation shareholder, an electing small business trust (ESBT) and a trust that is described in section 401(a) or section 501(c)(3) and is exempt from taxation under section 501(a) is not a deferral entity for purposes of §1.444-2T. The temporary regulations affect S corporations, ESBTs that own S corporation stock, and trusts that are described in section 401(a) or section 501(c)(3) and exempt from taxation under section 501(a) that own S corporation stock. The text of these temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking in REG-251701-96, page 396.

**DATES:** *Effective Date:* These regulations are effective December 29, 2000.

*Applicability Dates:* For dates of applicability, see §1.444-4T of these regulations.

**FOR FURTHER INFORMATION CONTACT:** Bradford Poston and James A. Quinn (202) 622-3060 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

#### Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) relating to the election of a taxable year other than the required taxable year under section 444. Section 444(d)(3) and §1.444-2T generally prohibit an S corporation that is a member of a tiered structure from making an election under section 444 for taxable years beginning after December 31, 1986. An S corporation is considered to be a member of a tiered structure if the S corporation owns any portion of a deferral entity, or a deferral entity owns any portion of an S corporation. Section 1.444-2T(b)(2) defines deferral entity to include any entity that is a trust with the exception of certain grantor trusts (including qualified subchapter S trusts within the meaning of section 1361(d)(1)(A)).

Section 1302 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755) (August 20, 1996), modified sections 641 and 1361 of the Internal Revenue Code (Code) to permit an electing small business trust (ESBT) to be an S corporation shareholder and also modified section 1361 to allow an organization (including a trust) that is described in section 401(a) or section 501(c)(3) and that is exempt from taxation under section 501(a) to be a shareholder of an S corporation. The temporary regulations under section 444 are also being issued as proposed regulations (REG-251701-96) on page 396 of this Bulletin.

#### Explanation of Provisions

The temporary regulations modify the temporary regulations under section 444 to provide that an ESBT and a trust that is described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) is not a deferral entity for purposes of §1.444-2T. Therefore, an S corporation with a section 444 election may have an ESBT or a trust that is described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) as a shareholder. An ESBT is not a deferral entity within the

meaning of §1.444-2T because under section 641(c) the portion of the ESBT consisting of stock in one or more S corporations is taxed to the deemed owner under subpart E, part I, subchapter J of the Code or is subject to taxation at the trust level without a deduction for amounts distributed or required to be distributed from that portion of the trust. A trust described in section 401(a) (other than an employee stock ownership plan described in section 4975(e)(7)), or a trust described in section 501(c)(3) that is exempt from taxation under section 501(a) is not a deferral entity within the meaning of §1.444-2T because with respect to such trust all items of income, loss, or deduction taken into account under section 1366(a) and any gain or loss on the disposition of the stock in the S corporation is treated as unrelated business taxable income of such trust under section 512(e)(1) and is subject to taxation under section 511. A trust described in section 401(a) that is an employee stock ownership plan described in section 4975(e)(7) is not a deferral entity within the meaning of §1.444-2T because such trust does not defer taxation but rather is exempt from taxation under section 501(a) and is not treated as having unrelated business taxable income pursuant to section 512(e)(3). The temporary regulations are effective as of December 29, 2000. However taxpayers may voluntarily apply these temporary regulations to taxable years of S corporations beginning after December 31, 1996, for S corporations that have ESBTs as shareholders, and for taxable years beginning after December 31, 1997, for S corporations that have trusts described in section 401(a) or section 501(c)(3) that are exempt from taxation under section 501(a) as shareholders.

#### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regula-

tions, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Small Business Administration for comment on the regulation's impact on small business.

### Drafting Information

The principal authors of these regulations are Bradford Poston and James A. Quinn of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.444-4T is also issued under 26 U.S.C. 444(g). \* \* \*

Par. 2. Section 1.444-4T is added under the undesignated centerheading "Accounting Periods" to read as follows:

*§1.444-4T Tiered structure (temporary).*

(a) *Electing small business trusts.* For purposes of §1.444-2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph (a) is applicable beginning December 29, 2000, however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) *Certain tax-exempt trusts.* For purposes of §1.444-2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a). An S corporation

with a trust that is described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) as a shareholder may make an election under section 444. This paragraph (b) is applicable beginning December 29, 2000, however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

Approved December 13, 2000.

Jonathan Talisman,  
*Acting Assistant Secretary  
of the Treasury.*

(Filed by the Office of the Federal Register on December 28, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 29, 2000, 65 F.R. 82926)

### Section 904.—Limitation on Credit

*26 CFR 1.904-4: Separate application of section 904 with respect to certain categories of income.*

#### T.D. 8916

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

### Application of Section 904 to Income Subject to Separate Limitations and Section 864(e) Affiliated Group Expense Allocation and Apportionment Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains Income Tax Regulations relating to the section 864(e)(5) and (6) rules on affiliated group interest and other expense allocation and apportionment and to the section 904(d) foreign tax credit limitation. Changes to the applicable laws were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1993, and the Taxpayer Relief Act of

1997. These regulations provide guidance needed to comply with those changes and affect individuals and corporations claiming foreign tax credits.

DATES: *Effective Date:* These regulations are effective January 3, 2001.

*Applicability Dates:* The specific dates of applicability of these regulations are as follows:

The amendments to §§1.861-9, 1.861-11, and 1.861-14 generally apply to taxable years beginning after December 31, 1989. The dates of applicability are stated in §1.861-9(h)(5)(i) and (ii), §1.861-11(d)(8), and §1.861-14(d)(1), (d)(2)(i), and (d)(2)(ii).

The amendment to §1.904-4(b)(1)(i) applies to taxable years beginning after December 31, 1992.

The amendments to §1.904-4(e)(3)(ii) and (e)(3)(iv) apply to taxable years beginning after December 31, 2000.

The amendments to §1.902-1(d)(3)(ii), §1.904-4(c)(5)(v), (c)(6)(iv), (c)(7)(ii), (c)(7)(iii), (c)(8) Example 9, and (g)(3), and to §1.904-5(d)(2) and (m) apply to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on §1.904-4(c)(6)(iv) and (g)(3)(ii), (iii), and (iv) of regulations project REG-209527-92, INTL-1-92, published at 1992-1 C.B. 1209. See §601.601(d)(2) of 26 CFR part 601 revised April 1, 2000.

The amendments to §1.904-5(a)(3), (g), (h)(4), and (i)(1), (3), and (4) apply to taxable years beginning after December 31, 2000. However, taxpayers may choose to apply the rule of §1.904-5(i)(3) in taxable years beginning after December 31, 1991, provided that the taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of the rule to taxable years that are not open for assessment.

ADDRESSES: Send submissions to: Regulations Unit CC (REG-106409-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to Regulations Unit CC (REG-106409-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the IRS Internet site at: [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html).



FOR FURTHER INFORMATION CONTACT: Bethany A. Ingwalson at (202) 622-3850 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

#### Background

On May 14, 1992, a notice of proposed rulemaking (INTL-1-92, 1992-1 C.B. 1209) was published in the **Federal Register** (57 F.R. 20660), proposing amendments to the temporary Income Tax Regulations (26 CFR part 1) under section 864(e)(5) and (6) and to the Income Tax Regulations (26 CFR part 1) under section 904(d). The proposed regulations under section 864(e)(5) and (6) concern the allocation and apportionment of interest expense and certain other expenses within an affiliated group for alternative minimum tax purposes. The proposed regulations under section 904(d) provide rules for determining a taxpayer's foreign tax credit limitation.

Also on May 14, 1992, final regulations (T.D. 8412, 1992-1 C.B. 271) under section 904(d) of the Internal Revenue Code of 1986 (Code) were published in the **Federal Register** (57 F.R. 20639). The final regulations added provisions that were reserved in final regulations (T.D. 8214, 1988-2 C.B. 220) published in the **Federal Register** (53 F.R. 27006) in 1988 and also made other changes to the 1988 final regulations. Written comments were received with respect to the final and proposed regulations and a public hearing was held on September 24, 1992.

On July 8, 1996, additional proposed amendments to the Income Tax Regulations under section 904 (REG-209750-95, 1996-2 C.B. 484) were published in the **Federal Register** (61 F.R. 35696), addressing the grouping rules under §1.904-4(c). On January 11, 1999, final regulations (T.D. 8805, 1999-1 C.B. 371) were published in the **Federal Register** (64 F.R. 1505) finalizing these amendments and portions of the 1992 proposed regulations, with modifications.

The significant points raised by the comments to the 1992 final and proposed regulations and at the hearing, and the changes made to the proposed, temporary, and final regulations, are discussed in the remainder of the preamble. After consideration of the comments received, the below-described amendments to the 1992

final regulations under section 904 and to the final regulations under section 864 are adopted as modified by this Treasury decision.

#### Explanation of Provisions

##### I. §§1.861-9, 1.861-11, and 1.861-14

The proposed regulations under §§1.861-9, 1.861-11, and 1.861-14 are finalized substantially as proposed, and the corresponding provisions of the temporary regulations are removed. For purposes of the alternative minimum tax (AMT), for taxable years beginning after December 31, 1989, the dividends received deduction under section 243 does not apply to the portion of a dividend attributable to income that is exempt from tax under section 936 or 30A. See section 56(g)(4)(C). Therefore, the exempt portion of the dividend is, in effect, included in adjusted current earnings (ACE) for purposes of computing the dividend recipient's alternative minimum taxable income. Dividends from a corporation with respect to which an election is in effect under section 936 or 30A (a section 936 corporation) are eligible for the dividends received deduction for regular tax purposes. Section 243(b)(1)(B)(ii).

To the extent included in income, dividends from a section 936 corporation to an affiliated United States corporation do not qualify for look-through treatment under section 904(d)(3) and §1.904-5. Under sections 904, 861(a)(2)(A), and 862(a)(2), such amounts generally are treated as foreign source passive income (except as otherwise provided in section 904(g)). For taxable years beginning after December 31, 1993, section 56(g)(4)(C)(iii)(IV), added to the Code as part of the Revenue Reconciliation Act of 1993 (Public Law 103-66, 107 Stat. 312) (RRA 1993), creates an AMT foreign tax credit separate limitation for dividend income attributable to income that is exempt from tax under section 936 or 30A. The separate limitation applies solely for AMT purposes.

Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, the portion of the dividends from section 936 corporations that are added back into alternative minimum taxable income as ACE adjustments are subject to the separate limitation for passive income

under section 904(d)(2) for AMT foreign tax credit purposes. For taxable years beginning after December 31, 1993, dividends from section 936 corporations are subject to a separate AMT foreign tax credit limitation. In addition, for taxable years beginning after December 31, 1995, corporations eligible for a credit under section 30A are treated as section 936 corporations, under sections 30A(e) and 56(g)(4)(C)(iii)(VI).

Treasury and the IRS proposed changes to the temporary regulations in order to exclude section 936 corporations from the affiliated group solely for purposes of allocating expenses in determining the amount of the group's foreign source alternative minimum taxable income, which affects the AMT foreign tax credit. This change has the effect of increasing the amount of interest and other expenses apportioned to dividend income from a section 936 corporation. The regulations were intended to mitigate the treatment, for AMT foreign tax credit purposes, of section 936 corporation dividends as passive income and would similarly mitigate the treatment of such dividends as separate limitation income in post-1993 taxable years.

Commentators wrote and testified at the public hearing that Treasury and the IRS do not have statutory authority to issue regulations under section 864(e)(5) excluding section 936 corporations from the affiliated group solely for AMT purposes. They contended that the AMT and regular tax systems must remain parallel unless a deviation is appropriate for simplification purposes. However, the enactment of a separate limitation category for certain portions of dividends from section 936 corporations for AMT purposes, effective for taxable years beginning after 1993, demonstrates that, because of the ACE adjustment, the AMT and regular tax foreign tax credit systems cannot operate exactly alike with respect to dividend income from section 936 corporations.

The amendments were proposed to apply to taxable years beginning after December 31, 1991. In response to a comment, the applicability date of the amendments to the regulations under §§1.861-9, 1.861-11, and 1.861-14 has been changed to taxable years beginning after December 31, 1989, to conform to the effective date of the statutory change.

The regulations also provide a definition of section 936 corporations that reflects the enactment of section 30A.

In addition, the regulations move the flush text at the end of §1.861-11T(d)(6) to a new §1.861-11(d)(7). The new paragraph (d)(7) provides, among other things, that the attribution rules of section 1563(e) rather than the rules of section 318 will apply to determine indirect ownership for purposes of §1.861-11T(d)(6). The change in the regulations to refer to section 1563(e) is consistent with paragraph 7 of Notice 89-91 (1989-2 C.B. 408), which stated that the IRS intends that the reference in §1.861-11T(d)(6) to section 318 should instead be a reference to section 1563(e), effective for all post-1986 taxable years.

## II. §1.904

### A. Changes to the 1992 Proposed Regulations.

#### 1. Distributions From Controlled Foreign Corporations That are not Eligible for Look-Through Treatment

Section 1.904-4(g)(3)(i) provides that distributions made by a controlled foreign corporation (CFC) from earnings and profits accumulated before the distributing corporation became a CFC are treated as dividends from a noncontrolled section 902 corporation. The final regulations reorganize the provisions of §1.904-4(g)(3) and include a reserved paragraph at §1.904-4(g)(3)(i)(C). The regulations are proposed to be amended in a separate document (REG-104683-00) published on page 407 of this Bulletin to address the effect of an intervening period when the corporation was not a CFC on the eligibility of the distributions for look-through treatment.

Prior to amendment by the Taxpayer Relief Act of 1997 (Public Law 105-34, 107 Stat. 312)(TRA 1997), section 904(d)(2)(E)(i) provided that a CFC would not be treated as a noncontrolled section 902 corporation with respect to distributions from earnings and profits that were accumulated while the corporation was a CFC and, except as provided in regulations, the taxpayer was a United States shareholder in such corporation. The rule limiting look-through treatment to earnings and profits accumulated while the taxpayer was a United States share-

holder was repealed by TRA 1997, applicable for distributions after August 5, 1997.

With respect to distributions before August 6, 1997, §1.904-4(g)(3)(ii) through (iv) of the proposed regulations significantly limited the circumstances under which a dividend paid to a new United States shareholder by a CFC out of earnings and profits accumulated while it was a CFC (but before the recipient became a United States shareholder) would be treated as dividends from a non-controlled section 902 corporation. The final regulations at §1.904-4(g)(3)(ii)(A) retain the proposed rule denying look-through treatment only to new United States shareholders that acquire more than 90 percent of a CFC. This rule relaxed the statutory limitation to the extent necessary to avoid the administrative burdens that would arise if more than one United States shareholder were entitled to look-through treatment on distributions of post-1986 undistributed earnings but the look-through pools for each new shareholder began in different years.

Commentators argued that the regulations should be further expanded to allow look-through on pre-acquisition earnings for all new shareholders that acquire at least 10 percent of the voting power of the stock of a CFC, that is, to all new shareholders entitled to compute a credit for deemed-paid taxes under section 902 and section 960. Treasury and the IRS declined to adopt the suggestion, because the proposed regulations already relaxed the statutory requirement to an appropriate extent.

A commentator suggested that the intra-group acquisition rule in §1.904-4(g)(3)(ii)(C) of the proposed regulations (paragraph (g)(3)(ii)(B) of the final regulations) should be revised to apply when the new and old shareholders of a CFC are related under the attribution rules of sections 318 and 958, rather than only to transfers within an affiliated group. Other commentators requested that the exception be expanded to apply to nontaxable transfers of stock in which the new and old shareholders cease to be members of the same affiliated group. Treasury and the IRS decline to expand the scope of the intra-group exception to the 90-percent shareholder rule, which applies only for distributions prior to August 6, 1997. The final regulations

clarify the rule of the proposed regulations that the dividend recipient and the immediately preceding owner (or owners) must be members of the same affiliated group both when the recipient acquires the stock of the distributing corporation from the immediately preceding owner and when the recipient receives the dividend.

In response to a comment, the regulations clarify the LIFO ordering rule in §1.904-4(g)(3)(iii) of the proposed regulations (paragraph (g)(3)(ii)(C) of the final regulations) for determining whether a distribution from a CFC is attributable to the period after a more-than-90-percent United States shareholder became a United States shareholder. The final regulations state that such a distribution comes first from the pool of post-acquisition undistributed earnings, next from the 10/50 pool of post-1986 undistributed earnings attributable to the pre-acquisition period, if any, and finally on a LIFO basis from any pre-acquisition earnings and profits attributable to pre-1987 accumulated profits.

To reflect the amendments made to section 904(d)(2)(E)(i) by TRA 1997, the final regulations provide at §1.904-4(g)(3)(ii)(D) that the denial of look-through treatment to new more-than-90-percent shareholders for distributions of earnings and profits accumulated before the recipient became a United States shareholder applies only to distributions made before August 6, 1997. Section 1.904-4(g)(3) has been reorganized to separate the rules under section 904(d)(2)(E) that are applicable to distributions after August 5, 1997, from the rules that are applicable only to distributions on or before that date.

Rules substantially identical to the proposed section 904 regulations were proposed in 1995 under section 902. See Prop. Reg. §1.902-1(d)(2)(ii) through (iv) (69 F.R. 2049; 1995-1 C.B. 959, 970), and the reserved paragraph at §1.902-1(d)(3)(ii) (1997). A commentator noted that the effective date included in the proposed section 902 regulations applied to taxable years beginning after December 31, 1986, while the proposed applicability date for the substantially identical regulations proposed under section 904(d) applied to taxable years beginning after December 31, 1991. Since sec-

tion 904(d)(2)(E)(i) applies to all taxable years beginning after 1986, the final regulations adopt the earlier applicability date, and amend the reserved paragraph at §1.902-1(d)(3)(ii) to add a cross reference to the final section 904 regulations.

## 2. Succeeding Shareholders' Treatment of Additional Taxes on Previously Taxed Income Recognized by Prior Shareholders

In response to a comment, §1.904-4(c)(6)(iv) of the proposed regulations is revised. Section 1.904-4(c)(6) provides rules for applying the high-tax kick-out from the passive limitation category when additional taxes are paid or deemed paid with respect to a distribution of previously taxed passive income that had been included in income in an earlier year under section 951(a)(1). Paragraph (c)(6)(iv) applies when a new shareholder acquires stock in a controlled foreign corporation after income has been included in the prior shareholder's income under section 951(a)(1) but before the income is distributed and subjected to additional foreign tax.

As proposed, paragraph (c)(6)(iv) provided that new shareholders entitled to look-through treatment on distributions of pre-acquisition earnings (U.S. shareholders that acquired 90 percent or less of the distributing corporation) would place the additional taxes in the general limitation category. However, new shareholders who were not entitled to look-through treatment (because the shareholder acquired more than 90 percent of the distributing corporation) would place the taxes in the general limitation or noncontrolled section 902 corporation category, depending on whether or not the associated income inclusion of the prior shareholder was high-taxed income.

A commentator argued that the latter rule's dependence on whether income was high-taxed or not in the hands of the previous shareholder, for purposes of determining the treatment of the taxes in the hands of a new 90-percent shareholder, added unnecessary complexity. In response to the comment, the regulations amend §1.904-4(c)(6)(iv) to provide that a shareholder not entitled to look-through on pre-acquisition earnings must treat the additional taxes as allocable to the non-controlled section 902 corporation divi-

dend category. The revised rule applies to taxable years beginning after December 31, 1991. However, taxpayers may rely on the proposed regulations for taxable years beginning before January 1, 2001.

The final regulations adopt the proposed rule that a shareholder entitled to look-through treatment on pre-acquisition earnings treats additional taxes imposed on distributions of previously taxed passive income as allocable to the general limitation category. This rule applies to all distributions of previously taxed passive income after August 5, 1997.

## 3. Special Rules for Dividends Between CFCs

Section 1.904-5(i)(3) of the proposed regulations, reducing to ten percent the common ownership threshold for dividends between CFCs to qualify for look-through treatment, is finalized as proposed, applicable to taxable years beginning after December 31, 2000. However, taxpayers may choose to apply the rule to taxable years beginning after December 31, 1991, so long as appropriate adjustments are made to eliminate any double benefit arising from the application of the rule to taxable years that are not open for assessment. *Example 2* of proposed §1.904-5(i)(4) is also finalized, with modifications described in II B.4 of this preamble, below, relating to changes to correct errors in *Example 1* in the 1992 final regulations.

## B. Changes to the 1992 Final Regulations.

### 1. Passive Limitation FOGEI Income

Section 1.904-4(b)(1)(i) is amended to clarify that, for taxable years beginning after December 31, 1992, passive income does not exclude foreign oil and gas extraction income (as defined in section 907(c)). This amendment reflects the repeal of section 904(d)(2)(A)(iii)(IV), which excluded FOGEI from the definition of passive income, by section 13235(a)(2) of RRA 1993.

### 2. High-tax Kickout

Section 1.904-4(c)(4)(ii) is revised to reflect the addition of §1.904-4(c)(3)(iv).

### 3. Reduction in Tax on Distribution of Previously Taxed Income

The 1992 final regulations, which generally look to foreign law rules for purposes of determining the year or years to which a reduction in foreign tax relates, were intended to apply LIFO default rules in order to avoid multiple redeterminations under section 905(c) in situations where a tax reduction applies to a distribution of previously taxed income that is treated under foreign law as made out of a multi-year pool of income. See §1.905-3T(f) (requiring a redetermination of deemed paid taxes, in lieu of a pooling adjustment, when corporate tax is reduced in connection with a distribution of previously taxed income).

In response to a comment, §1.904-4(c)(7)(ii) and §1.904-4(c)(8) *Example 9* are revised to clarify that if a foreign country's law allocates a foreign tax reduction to a pool or group containing income from more than one taxable year, and that pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than based on the taxable year in which the income is derived, then foreign law is not considered to specify a year or years to which the tax reduction applies and the last-in first-out (LIFO) default rule applies.

In response to a comment, a new paragraph (c)(5)(v) has been added to §1.904-4 to supply a cross-reference to the rule that, pursuant to the general rule of section 904(d)(3)(E), passive income excluded from foreign personal holding company income under the subpart F high tax exception of section 954(b)(4) will be treated as general limitation income at the CFC level unless the special rule in §1.904-4(c)(7)(iii) applies.

## 4. Examples Illustrating Look-Through Rules for Dividends and Interest

In response to comments, §1.904-5(i)(4) *Example 1* and Prop. §1.904-5(i)(4) *Example 2* are revised. The 1992 version of *Example 1* was erroneous because, although the first-tier CFC in that example owns only 40 percent of the second-tier CFC, the second-tier CFC owns 100 percent of the third-tier CFC. Therefore, the second- and third-tier CFCs are related look-through entities and the look-through rules of §1.904-5(i)(1) apply to interest payments between them. The section 904(d)(3)(B)



look-through rule for subpart F inclusions applies to the U.S. parent's recognition of subpart F income of the second-tier CFC, attributable to the interest paid by the third-tier CFC.

*Example 2* of the proposed regulations reached the correct result but applied an incorrect rationale. Just as in *Example 1*, on the facts of proposed *Example 2*, the related look-through entity rules of §1.904-5(i)(1) would apply to distributions between the second- and third-tier CFCs even without the application of the special rule for dividends in proposed §1.904-5(i)(3). *Examples 1* and *2* are revised to illustrate the different ownership thresholds that are required in order for the look-through rules to apply to interest and dividends paid between CFCs. The regulations also add a new *Example 3* to further clarify the application of §1.904-5(i).

#### 5. Treatment of Section 951(a)(1)(B) Inclusions as Dividends

Paragraph (m)(4) of §1.904-5 is amended to clarify that, for purposes of the section 904(g) re-sourcing rules, section 951(a)(1)(B) inclusions are treated as dividends sourced under the *pro rata* rule of section 904(g)(4) and §1.904-5(m)(4). Section 904(g)(2) provides a rule for sourcing section 951(a) inclusions, which literally include section 956 inclusions described in section 951(a)(1)(B). Section 904(g)(2) treats an amount described in section 951(a) as U.S. source income to the extent it is attributable to items of U.S. source income of the foreign corporation. Inclusions under section 951(a)(1)(A) are measured by tracing the inclusion directly to the items of income received by a CFC. Like an actual dividend, an increase in earnings invested in U.S. property that is included in income under section 951(a)(1)(B) is treated as paid *pro rata* out of all of the CFC's earnings and profits. See §1.904-5(c)(4)(i). The final regulations amend §1.904-5(m)(4)(i) to clarify that section 904(g)(2) sources section 951(a)(1)(B) inclusions by applying the *pro rata* rules of section 904(g)(4).

#### 6. Treatment of Base Differences in the Case of Financial Services Entities

A commentator requested that §1.904-6(a)(1)(iv) be revised to provide

that, in the case of a financial services entity, if foreign taxes are imposed on amounts that are not income under United States tax rules (a base difference), the foreign taxes will be placed in the limitation category for financial services income rather than the general limitation category. The commentator argued that financial services entities typically have no general limitation income, and that the financial services category essentially serves as the residual basket for financial services entities.

Treasury and the IRS decline to adopt the suggested change. Treasury and the IRS believe that most cases in which foreign tax is imposed in the absence of a concurrent associated income inclusion in the United States are properly analyzed as involving a timing difference rather than a base difference. A timing difference occurs when foreign tax is imposed on an item that would be income under United States tax principles if it were recognized for U.S. tax purposes in the same year. Treasury and the IRS believe that base differences (in which foreign tax is imposed on an amount that the United States would never recognize as income, such as a gift) rarely occur. Accordingly, a special rule for base differences of financial services entities is not required.

However, Treasury and the IRS are considering whether additional rules are needed to clarify the operation of §1.904-6(a)(1)(iv). For example, Treasury and the IRS are considering whether the regulations should be revised to address explicitly situations in which a foreign country and the United States recognize different amounts of income or characterize the income differently, for example, as a result of differences in calculating basis. Other issues under consideration include the appropriate treatment of situations in which a timing difference occurs but there is more than one possible characterization of the income that might be recognized in the future for U.S. tax purposes, and situations in which the United States and another country perceive different taxpayers as realizing the same income (with or without a timing or characterization difference). Comments are requested on the appropriate scope and content of additional guidance on these types of issues.

Treasury and the IRS are also considering clarifying §1.904-6(a)(1), which pro-

vides rules for allocating foreign taxes to separate categories. The current regulations determine the income to which the foreign taxes relate by reference to foreign law (taxes are related to income if the income is included in the tax base upon which the foreign tax is imposed). Foreign taxes are allocated and apportioned to separate categories by reference to the separate categories to which the income taxed under foreign law would be assigned under U.S. tax principles. See §1.904-6(c) *Example 5*. Comments are requested on the manner in which the regulations could be made easier to understand and apply.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal author of these final regulations is Rebecca I. Rosenberg of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding citations for §§1.861-9, 1.861-11 and 1.861-14 to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.861-9 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). \* \*

Section 1.861-11 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). Section 1.861-14 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). \* \*

Par. 2. Section 1.861-9 is added to read as follows:

*§1.861-9 Allocation and apportionment of interest expense.*

(a) through (h)(4) [Reserved]. For further guidance, see §1.861-9T(a) through (h)(4).

(h)(5) *Characterizing stock in related persons*—(i) *General rule.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of §1.861-12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under §1.861-9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under §1.904-4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax.* For purposes of characterizing stock in a related section 936 corporation in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a), the rules of §1.861-9T(g)(3) shall apply and §1.861-9(h)(5)(i) shall not apply. Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, stock in a related section 936 corporation is characterized for alternative minimum tax purposes as a foreign source passive asset because the stock produces foreign source passive dividend

income under sections 861(a)(2)(A), 862(a)(2), and 904(d)(2)(A) and the regulations under those sections. For taxable years beginning after December 31, 1993, stock in a related section 936 corporation would be characterized for alternative minimum tax purposes as an asset subject to the separate limitation for section 936 corporation dividends because the stock produces foreign source dividend income that, for alternative minimum tax purposes, is subject to a separate foreign tax credit limitation under section 56(g)(4)(C)(iii)(IV). However, stock in a section 936 corporation is characterized as a U.S. source asset to the extent required by section 904(g). For the definition of the term *section 936 corporation* see §1.861-11(d)(2)(ii).

(iii) *Effective date.* This paragraph (h)(5) applies to taxable years beginning after December 31, 1989.

Par. 3. In §1.861-9T, paragraph (h)(5) is revised to read as follows:

*§1.861-9T Allocation and apportionment of interest expense (temporary).*

\* \* \* \* \*

(h) \* \* \*

(5) [Reserved]. For further guidance, see §1.861-9(h)(5).

\* \* \* \* \*

Par. 4. Section 1.861-11 is added to read as follows:

*§1.861-11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.*

(a) through (c) [Reserved]. For further guidance, see §1.861-11T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, in general, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year,

only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to the other members of the group.

(2) *Inclusion of section 936 corporations*—(i) *Rule*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(i)(B) of this section, the exclusion of section 936 corporations from the affiliated group under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is a member of the affiliated group.

(B) *Exception for purposes of alternative minimum tax.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(ii) *Section 936 corporation defined.* For purposes of this section, §1.861-9, and §1.861-14, the term *section 936 corporation* means, for any taxable year, a corporation with an election in effect to be eligible for the credit provided under section 936(a)(1) or section 30A for the taxable year.

(iii) *Example.* This example illustrates the provisions of paragraph (d)(2)(i) of this section:

*Example*—(A) *Facts.* X owns all of the stock of Y. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. In 2000, Y owns all of the stock of Z, a section 936 cor-

poration. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. For purposes of section 904, Z's qualified possessions source investment income constitutes foreign source passive income. In computing the section 30A benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) *Analysis for regular tax.* Assume first that X has no alternative minimum tax liability. Under paragraph (d)(2) of this section, Z is treated as a member of the XY affiliated group for purposes of allocating and apportioning interest expense for regular tax purposes. As provided in §1.861-11T(b)(2), section 864(e)(1) and (5) do not apply in computing the combined taxable income of Y and Z under section 936, but these rules do apply in computing the foreign source taxable income of the XY affiliated group. The effect of including Z in the affiliated group is that X, the only debtor corporation in the group, must, under the asset method described in §1.861-9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(f), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(C) *Analysis for alternative minimum tax.* Assume, alternatively, that X is liable to pay the alternative minimum tax. Pursuant to section 59(a), X must compute its alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income. Under paragraph (d)(2)(i)(B) of this section, for purposes of the apportionment of interest expense in determining alternative minimum taxable income within each limitation category, Z is not considered a member of the XY affiliated group. Thus, the stock (and not the assets) of Z are included in computing the group apportionment fractions. Pursuant to sections 59(g)(4)(C)(iii)(IV), 861(a)(2)(A), and 862(a)(2), dividends paid by a section 936 corporation are foreign source income subject to a separate foreign tax credit limitation for alternative minimum tax purposes. Thus, under §1.861-9T(g)(3), the stock of Z must be considered attributable solely to the statutory grouping consisting of foreign source dividends from Z. The effect of excluding Z from the affiliated group is that X must apportion a part of its interest expense to the separate category for foreign source dividends from Z in computing alternative minimum taxable income within each separate category. If, as a result, under section 904(f), X has a separate limitation loss or an overall foreign loss in the category for dividends from Z for alternative minimum tax purposes, then that loss must be allocated against X's other income (separate limitation or United States source, as the

case may be). The loss must be recaptured in subsequent years under the rules of section 904(f) for purposes of the alternative minimum tax foreign tax credit. \* \* \*

(iv) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (6) [Reserved]. For further guidance see §1.861-11T(d)(3) through (6).

(7) *Special rules for the application of §1.861-11T(d)(6).* The attribution rules of section 1563(e) and the regulations under that section shall apply in determining indirect ownership under §1.861-11T(d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in §1.861-11T(d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under §1.861-11T(g). The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of §1.861-11T(g). For taxable years beginning after December 31, 1989, §1.861-11T(d)(6)(i) shall not apply in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a) to the extent that such application would result in the inclusion of a section 936 corporation within the affiliated group. This paragraph (d)(7) applies to taxable years beginning after December 31, 1986.

(e) through (g) [Reserved]. For further guidance, see §1.861-11T(e) through (g).

Par. 5. Section 1.861-11T is amended by:

1. Revising paragraphs (d)(1) and (d)(2).
2. Removing the concluding text following (d)(6)(ii).
3. Adding paragraph (d)(7).

The revisions and additions read as follows:

*§1.861-11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).*

\* \* \* \* \*

(d) (1) and (2) [Reserved]. For further guidance, see §1.861-11T(d)(1) and (2).

\* \* \* \* \*

(7) *Special rules for the application of §1.861-11T(d)(6).* [Reserved]. For special rules for the application of §1.861-11T(d)(6), see §1.861-11T(d)(7).

\* \* \* \* \*

Par. 6. Section 1.861-14 is added to read as follows:

*§1.861-14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.*

(a) through (c) [Reserved]. For further guidance, see §1.861-14T(a) through (c).

(d) *Definition of affiliated group—(1) General rule.* For purposes of this section, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations (as defined in §1.861-11T(d)(2)(ii)) are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80% stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the expenses incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, the apportionment factor chosen shall relate only to the period of membership. For example, if apportionment on the basis of assets is chosen, the average amount of assets (tax book value or fair market value) for the taxable year shall be multiplied by a fraction, the numerator of which is the number of months of the corporation's taxable year during which the corporation was a member of the affiliated group, and the denominator of which is the number of months within the corporation's taxable year. If apportionment on the basis of gross income is chosen, only gross income generated during the period of membership shall be taken into account. If apportionment on the basis of units sold or sales receipts is chosen, only



units sold or sales receipts during the period of membership shall be taken into account. Expenses incurred by the group member during its taxable year, but not during the period of membership, shall be allocated and apportioned without regard to other members of the group. This paragraph (d)(1) applies to taxable years beginning after December 31, 1989.

(2) *Inclusion of section 936 corporations*—(i) *General rule.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is a member of the affiliated group.

(ii) *Exception for purposes of alternative minimum tax.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(iii) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (j) [Reserved]. For further guidance see §1.861-14T(d)(3) through (j).

Par. 7. In §1.861-14T, paragraph (d) is revised to read as follows:

*§1.861-14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (temporary).*

\* \* \* \* \*

(d)(1) and (2) [Reserved]. For further guidance, see §1.861-14(d)(1) and (2).

\* \* \* \* \*

Par. 8. Section 1.902-1(d)(3)(ii) is amended by adding text to read as follows:

*§1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.*

\* \* \* \* \*

(d) \* \* \*

(3) \* \* \*

(ii) \* \* \* For rules regarding dividend distributions before August 6, 1997, to certain more-than-90-percent United States shareholders of a controlled foreign corporation, see §1.904-4(g)(3)(ii).

\* \* \* \* \*

Par. 9. Section 1.904-0 is amended as follows:

1. Amending the entries for §1.904-4 by:

a. Adding entries for paragraphs (c)(5)(v), (c)(6)(iv)(A), and (c)(6)(iv)(B).

b. Adding an entry for paragraph (g)(2)(v).

c. Revising the entries for paragraphs (g)(3) and (g)(3)(i).

d. Adding entries for paragraphs (g)(3)(i)(A), (g)(3)(i)(B), (g)(3)(i)(C), and (g)(3)(i)(D).

e. Revising the entry for paragraph (g)(3)(ii).

f. Adding entries for paragraphs (g)(3)(ii)(A), (g)(3)(ii)(B), (g)(3)(ii)(C), (g)(3)(ii)(D), and (g)(3)(ii)(E).

g. Revising the entries for paragraphs (g)(3)(iii) and (g)(3)(iv).

h. Adding an entry for paragraph (g)(3)(v).

i. Removing the entry for paragraph (g)(4).

The revisions and additions read as follows:

*§1.904-0 Outline of regulation provisions for section 904.*

\* \* \* \* \*

*§1.904-4 Separate application of section 904 with respect to certain categories of income.*

\* \* \* \* \*

(c) \* \* \*

(5) \* \* \*

(v) Coordination with section 954(b)(4).

(6) \* \* \*

(iv) \* \* \*

(A) General rule.

(B) Exception for U.S. shareholders not entitled to look-through.

\* \* \* \* \*

(g) \* \* \*

(2) \* \* \*

(v) Examples.

(3) Special rule for dividends paid by a controlled foreign corporation.

(i) Distributions out of earnings and profits accumulated when the distributing corporation was not a controlled foreign corporation.

(A) General rule.

(B) Ordering rule.

(C) Effect of intervening noncontrolled status.

(D) Examples.

(ii) Pre-August 6, 1997, dividend distributions out of earnings and profits accumulated before a more-than-90-percent United States shareholder became a United States shareholder.

(A) General rule.

(B) Exception for intra-group acquisitions.

(C) Ordering rule.

(D) Distributions after August 5, 1997.

(E) Examples.

(iii) Treatment of earnings and profits for transition year.

(iv) Definitions.

(v) Effective date.

\* \* \* \* \*

Par. 10. Section 1.904-4 is amended by:

1. Revising the second sentence in paragraph (b)(1)(i)(B).

2. Revising paragraph (c)(4)(ii).

3. Adding a new paragraph (c)(5)(v).

4. Adding the text to paragraph (c)(6)(iv).

5. Adding a new sentence at the end of paragraph (c)(7)(ii).

6. Revising the second sentence of paragraph (c)(7)(iii).

7. Amending paragraph (c)(8) by revising the fifth sentence of paragraph (i) of *Example 9*, and the fifth sentence of paragraph (ii) of *Example 9*.

8. Revising paragraph (e)(3)(ii).

9. Adding the text to paragraph (e)(3)(iv) *Example 2*.

10. Redesignating paragraph (g)(4) as paragraph (g)(2)(v).

11. Revising the heading for paragraph (d)(3) and revising paragraph (g)(3)(i).

12. Revising the paragraph headings and adding the text to paragraphs (g)(3)(ii) through (iv).

13. Adding paragraph (g)(3)(v).

The revisions and additions read as follows:



*§1.904-4 Separate application of section 904 with respect to certain categories of income.*

\*\*\*\*\*

(b) \*\*\* (1) \*\*\* (i) \*\*\*

(B) \*\*\* Passive income does not include any income that is also described in section 904(d)(1)(B) through (H), any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section, or, for taxable years beginning before January 1, 1993, any foreign oil and gas extraction income (as defined in section 907(c)). \*\*\*

\*\*\*\*\*

(c) \*\*\*

(4) \*\*\*

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the tax imposed on that income as provided in paragraphs (c)(3)(i) through (iv) of this section.

\*\*\*\*\*

(5) \*\*\*

(v) *Coordination with section 954(b)(4).* For rules relating to passive income of a controlled foreign corporation that is exempt from subpart F treatment because the income is subject to high foreign tax, see section 904(d)(3)(E), §1.904-4(c)(7)(iii), and §1.904-5(d)(2).

(6) \*\*\*

(iv) *Increase in taxes paid by successors—(A) General rule.* Except as provided in paragraph (c)(6)(iv)(B) of this section, if passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid or accrued, on that distribution shall be treated as taxes related to general limitation income, regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(B) *Exception for U.S. shareholders not entitled to look-through.* In the case of a United States shareholder that, by reason of paragraph (g)(3)(ii) of this section (relating to distributions prior to August 6,

1997, to new shareholders acquiring more than 90 percent of a controlled foreign corporation), is not entitled to look-through treatment with respect to pre-acquisition earnings and profits of the distributing corporation, the increase in foreign taxes described in paragraph (c)(6)(iv)(A) of this section shall be treated as taxes related to the noncontrolled section 902 corporation income of the distributing corporation.

(C) *Effective date.* This paragraph (c)(6)(iv) applies to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on §1.904-4(c)(6)(iv) of regulations project INTL-1-92, published at 1992-1 C.B. 1209. See §601.601(d)(2) of this chapter.

(7) \*\*\*

(ii) \*\*\* For purposes of this paragraph (c)(7)(ii), foreign law is not considered to attribute a reduction in tax to a particular year or years if foreign law attributes the tax reduction to a pool or group containing income from more than one taxable year and such pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than on the taxable year in which the income is derived.

(iii) \*\*\* If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then, notwithstanding the general rule of §1.904-5(d)(2), the income shall be considered to be passive income until distribution of that income. \*\*\*

(8) \*\*\*

*Example 9.* (i) \*\*\* Under country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50% tax rate. \*\*\*

(ii) \*\*\* Country G treats the distribution of earnings as out of the 50% tax rate pool of earnings accumulated in 1987 and 1988. \*\*\*

\*\*\*\*\*

(e) \*\*\*

(3) \*\*\*

(ii) *Special rule for affiliated groups.* In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group, such corporation will be deemed to be a financial services enti-

ty if the affiliated group as a whole meets the requirements of paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), affiliated group means an affiliated group as defined in section 1504(a), determined without regard to section 1504(b)(3). In counting the income of the group for purposes of determining whether the group meets the requirements of paragraph (e)(3)(i) of this section, the following rules apply. Only the income of group members that are United States corporations or foreign corporations that are controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock shall be included. For purposes of this paragraph (e)(3)(ii), indirect ownership shall be determined under section 318 and the regulations under that section. The income of the group will not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii). This paragraph (e)(3)(ii) applies to taxable years beginning after December 31, 2000.

\*\*\*\*\*

(iv) \*\*\*

*Example 2.* Foreign corporation A, which is not a controlled foreign corporation, owns 100 percent of the stock of domestic corporation B, which owns 100 percent of the stock of domestic corporation C. A also owns 100 percent of the stock of foreign corporation D. D owns 100 percent of the stock of domestic corporation E, which owns 100 percent of the stock of controlled foreign corporation F. All of the corporations are members of an affiliated group within the meaning of section 1504(a) (determined without regard to section 1504(b)(3)). Pursuant to paragraph (e)(3)(ii) of this section, however, only the income of B, C, E, and F is counted in determining whether the group meets the requirements of paragraph (e)(3)(i) of this section. For the 2001 taxable year, B's income consists of \$95 of active financing income and \$5 of passive non-active financing income. C has \$40 of active financing income and \$20 of passive non-active financing income. E has \$70 of active financing income and \$15 of passive non-active financing income. F has \$10 of passive income. B and E qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. Therefore, B and E are financial services entities without regard to whether the group as a whole is a financial services entity and all of the income of B and E shall be treated as financial services income. C and F do not qualify as financial services entities under the entity test of paragraph

(e)(3)(i) of this section. However, under the affiliated group test of paragraph (e)(3)(ii) of this section, C and F are financial services entities because at least 80 percent of the group's total income consists of active financing income (\$205 of active financing income is 80.4 percent of \$255 total income). B's and E's passive income is not treated as active financing income for purposes of the affiliated group test of paragraph (e)(3)(ii) of this section even though it is treated as financial services income without regard to whether the group satisfies the affiliated group test. Once C and F are determined to be financial services entities under the affiliated group test, however, all of the passive income of the group is treated as financial services income. Thus, 100 percent of the income of B, C, E, and F for 2001 is financial services income.

\* \* \* \* \*

(g) \* \* \*

(3) *Special rule for dividends paid by a controlled foreign corporation*—(i) *Distributions out of earnings and profits accumulated when the distributing corporation was not a controlled foreign corporation*—(A) *General rule.* Distributions from a controlled foreign corporation shall be treated as dividends from a noncontrolled section 902 corporation, and therefore not subject to the look-through rules of §1.904–5, to the extent that the distribution is out of earnings and profits accumulated during periods when the distributing corporation was not a controlled foreign corporation.

(B) *Ordering rule.* The determination of the earnings to which a distribution from a controlled foreign corporation is attributable shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from post-1986 undistributed earnings attributable to the period after the distributing corporation became a controlled foreign corporation (look-through pools), next from the non-look-through pool of post-1986 undistributed earnings, if any, and finally on a LIFO basis from pre-1987 accumulated profits.

(C) *Effect of intervening noncontrolled status.* [Reserved]

(D) *Examples.* The following examples illustrate the application of paragraph (g)(3)(i):

*Example 1.* S is a foreign corporation formed in 1980. Until 1992, S had no United States shareholders. In 1992, P, a domestic corporation, acquires 10 percent of the stock of S. Thus, for 1992 and subsequent years, S is a noncontrolled section 902 corporation. Because the 10-percent ownership requirement of section 902(a) was not satisfied until 1992, earnings accumulated by S before 1992 will be treated as pre-1987 accumulated profits for purposes of

section 902, and the amount of foreign taxes deemed paid with respect to any distribution out of such pre-1987 accumulated profits will be computed on a year-by-year basis under the rules of section 902(c)(6)(A) and §1.902–1(b)(3). In 2000, P acquires an additional 45% of the stock of S. Thus, for 2000 and subsequent years, S is a controlled foreign corporation. In 2000, S has no earnings and profits and pays a dividend out of prior years' earnings and profits. Pursuant to paragraph (g)(3)(i) of this section, because S was not a controlled foreign corporation before 2000, the dividend to P will be treated as a dividend from a noncontrolled section 902 corporation. The dividend is treated as paid first out of S's non-look-through pool of post-1986 undistributed earnings to the extent thereof, and then out of S's pre-1987 accumulated profits on a LIFO basis. The entire dividend will be subject to a single separate limitation for dividends from a noncontrolled section 902 corporation.

*Examples 2 through 4.* [Reserved]

(ii) *Pre-August 6, 1997, dividend distributions out of earnings and profits accumulated before a more-than-90-percent United States shareholder became a United States shareholder*—(A) *General rule.* Look-through principles do not apply to distributions made before August 6, 1997, to a more-than-90-percent United States shareholder in the distributing corporation, to the extent the distributions are made from earnings and profits accumulated before the taxpayer became a United States shareholder of the distributing corporation (pre-acquisition earnings). Therefore, in the case of a distribution made before August 6, 1997, a dividend shall be treated as a dividend from a noncontrolled section 902 corporation, and the look-through rules of section 904(d)(3) and §1.904–5 shall not apply, if—

(1) The distribution is received by a United States shareholder, or by an upper-tier controlled foreign corporation of a United States shareholder, at a time when such United States shareholder is a more-than-90-percent United States shareholder of the distributing corporation; and

(2) The more-than-90-percent United States shareholder was not a United States shareholder at the time the distributed earnings and profits were accumulated by the distributing corporation.

(B) *Exception for certain intra-group acquisitions.* Notwithstanding paragraph (g)(3)(ii)(A) of this section, a dividend recipient shall be entitled to look-through treatment on a distribution out of pre-acquisition earnings if—

(1) The dividend recipient is a United States shareholder of the distributing corporation;

(2) The immediately preceding owner or owners were entitled to look-through treatment on distributions from the distributing corporation (determined after the application of paragraphs (g)(3)(i) and (g)(3)(ii)(A) of this section); and

(3) Both at the time of such distribution and at the time that the dividend recipient acquired its interest from such immediately preceding owner or owners, such recipient and such preceding owner or owners are members of the same affiliated group (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)).

(C) *Ordering rule.* If, under paragraph (g)(3)(ii) of this section (or under paragraphs (g)(3)(i)(A) and (g)(3)(ii) of this section), a shareholder is not entitled to look-through treatment, the determination whether a distribution from its controlled foreign corporation is attributable to pre-acquisition earnings shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from the post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation, and then from pre-acquisition earnings, in the order described in paragraph (g)(3)(i)(B) of this section.

(D) *Distributions after August 5, 1997.* Look-through principles shall apply to distributions made after August 5, 1997, to a distribution from a controlled foreign corporation to a more-than-90-percent United States shareholder out of pre-acquisition earnings that were accumulated in years during which the corporation was a controlled foreign corporation. Post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation and other post-1986 undistributed earnings accumulated while the distributing corporation was a controlled foreign corporation shall be combined into a single set of post-1986 undistributed earnings pools for each separate category described in §1.904–5(a)(1) as of August 6, 1997.

(E) *Examples.* The following examples illustrate the application of this paragraph (g)(3)(ii):

*Example 1.* (i) P, a domestic corporation, owns 100 percent of the stock of U, a controlled foreign corporation. In 1992, P sells 100 percent of the



stock of U to T, an unrelated domestic corporation. In 1992, U has no earnings and pays a dividend to T out of earnings and profits attributable to prior years. T is not related to P and P's ownership of U will not be attributed to T. Because the dividend to T in 1992 is out of post-1986 undistributed earnings that are pre-acquisition earnings, the dividend will be treated as a dividend from a noncontrolled section 902 corporation. In 1993, U pays a dividend to T out of current earnings and profits. T is entitled to look-through treatment on the dividend.

(ii) In September 1997, U pays a dividend to T out of both post-acquisition earnings and pre-acquisition earnings accumulated while U was a controlled foreign corporation. Under paragraph (g)(3)(ii)(D) of this section, T is entitled to look-through treatment on the full amount of the dividend.

*Example 2.* (i) Domestic corporation P has owned 95 percent of the stock of S, a controlled foreign corporation, from the time of S's organization in 1990. Domestic corporation R owns the remaining 5 percent of the stock of S. On December 1, 1996, T, an unrelated domestic corporation, acquires P's 95 percent interest in S. On December 31, 1996, S pays a dividend out of current and prior years' earnings and profits. T is a more-than-90-percent United States shareholder of S at the time it receives the dividend, but was not a United States shareholder at the time the distributed earnings were accumulated. Under this paragraph (g)(3)(ii), the portion of the dividend to T attributable to pre-acquisition earnings will be treated as a dividend from a noncontrolled section 902 corporation. Under paragraph (g)(3)(iii) of this section, T will be entitled to look-through treatment on the portion of the dividend attributable to 1996 earnings and profits. Under paragraph (g)(3)(ii)(C) of this section, the dividend received by T will be treated as coming first from S's post-1986 undistributed earnings attributable to 1996, and then from pre-acquisition earnings.

(ii) On December 31, 1997, S pays a second dividend out of current and prior years' earnings and profits. Under paragraph (g)(3)(ii)(D) of this section, T will be entitled to look-through treatment on the full amount of the dividend because all of S's earnings and profits were accumulated in years during which S was a controlled foreign corporation. The dividends to R will be treated as passive income because R owns less than 10 percent of the stock of S and, therefore, is not entitled to look-through treatment.

*Example 3.* The facts are the same as in *Example 2* except that R, rather than T, acquires from P an 86 percent interest in S in 1996. Although R was a shareholder of S before the acquisition, it was not a United States shareholder because it did not own 10 percent of the voting stock of S. Thus, because R owns more than 90 percent of the stock of S, and received a distribution of earnings before August 7, 1997, that were accumulated before it became a United States shareholder of S, this paragraph (g)(3)(ii) applies and R is not entitled to look-through treatment on the 1996 dividend. R is entitled to look-through treatment on the 1997 dividend.

*Example 4.* Since its organization in 1980, S, a controlled foreign corporation, has been owned 60 percent by domestic corporation P and 40 percent by domestic corporation R. On November 15, 1996, domestic corporation T acquires R's 40 percent

interest in the stock of S. S has no income in 1996 and pays a dividend on December 15, 1996, out of prior years' earnings and profits. This paragraph (g)(3)(ii) does not apply because T acquired less than 90 percent of the stock of S. Thus, T is entitled to look-through treatment on dividends distributed out of pre-acquisition earnings, because such earnings are attributable to periods in which S was a controlled foreign corporation.

(iii) *Treatment of earnings and profits accumulated in a transition year.* Earnings and profits accumulated in the taxable year in which a corporation became a controlled foreign corporation or in which a more-than-90-percent United States shareholder became a United States shareholder shall be considered earnings and profits accumulated after the corporation became a controlled foreign corporation or the shareholder became a United States shareholder, respectively.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (g)(3):

(A) *More-than-90-percent United States shareholder.* The term *more-than-90-percent United States shareholder* means, with respect to any controlled foreign corporation, a United States shareholder that owns more than 90 percent of the total combined voting power of all classes of stock entitled to vote of the controlled foreign corporation. In determining ownership for purposes of this definition, the indirect stock ownership rules of sections 958 and 318 and the regulations under those sections shall apply.

(B) *Non-look-through pool.* Except as otherwise provided, the term *non-look-through pool* means post-1986 undistributed earnings accumulated during periods in which the distributing corporation was a noncontrolled section 902 corporation that was not a controlled foreign corporation.

(C) *Post-1986 undistributed earnings.* The term *post-1986 undistributed earnings* has the meaning set forth in §1.902-1(a)(9).

(D) *Pre-1987 accumulated profits.* The term *pre-1987 accumulated profits* has the meaning set forth in §1.902-1(a)(10).

(E) *Upper tier controlled foreign corporation.* The term *upper tier controlled foreign corporation* of a United States shareholder means a controlled foreign corporation in which the taxpayer is a

United States shareholder and which is an upper-tier corporation as defined in §1.902-1(a)(6) with respect to the distributing corporation.

(v) *Effective date.* The provisions of this paragraph (g)(3) apply to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on §1.904-4(g)(3)(ii), (iii) and (iv) of regulations project INTL-1-92, published at 1992-1 C.B. 1209. See §601.601(d)(2) of this chapter.

\* \* \* \*

Par. 11. Section 1.904-5 is amended as follows:

1. The last sentence in paragraph (a)(3) is revised and one new sentence is added.

2. Paragraph (d)(2) is amended by removing the word "For" at the beginning of the first sentence and adding the language "Except as provided in §1.904-4(c)(7)(iii) (relating to reductions in tax upon distribution), for" in its place.

3. Paragraph (g) is revised.

4. Paragraph (h)(4) is amended by adding three new sentences at the end.

5. Paragraph (i)(1) is amended by:

a. Revising the third sentence.

b. Adding a new sentence at the end.

6. The text to paragraph (i)(3) is added.

7. Paragraph (i)(4) *Example 1* is revised.

8. The text to paragraph (i)(4) *Example 2* is added.

9. Paragraph (i)(4) *Example 3* is added.

10. The second and third sentences of paragraph (m)(1) are revised.

11. Paragraph (m)(4)(i) is revised.

12. Paragraph (m)(5) is amended by removing the language "951(a)" from the first sentence and adding the language "951(a)(1)(A)" in its place.

The revisions and additions read as follows:

*§1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.*

(a) \* \* \*

(3) \* \* \* For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that "more than 50 percent" shall be substituted for "at least 80 percent" wherever it appears in section 1504(a)(2). For taxable years beginning

before January 1, 2001, the preceding sentence shall be applied by substituting "50 percent" for "more than 50 percent".

\* \* \* \* \*

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents and royalties paid by a United States corporation to a related corporation. For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock of the other corporation or more than 50 percent of the total value of the other corporation. In addition, a United States corporation and another corporation shall be considered to be related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock or more than 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 and the regulations under that section apply. For taxable years beginning before January 1, 2001, this paragraph (g) shall be applied by substituting "50 percent or more" for "more than 50 percent" each place it appears.

(h) \* \* \*

(4) \* \* \* Similarly, a partnership (first partnership) is considered as owning more than 50 percent of the value of another partnership (second partnership) if the first partnership owns more than 50 percent of the capital and profits interests of the second partnership. For this purpose, value will be determined at the end of the partnership's taxable year. For taxable years beginning before January 1, 2001, the second preceding sentence shall be applied by substituting "50 percent" for "more than 50 percent".

(i) \* \* \* (1) \* \* \* In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. \* \* \* For taxable years beginning before January 1, 2001, the

third sentence of this paragraph (i)(1) shall be applied by substituting "50 percent or more" for "more than 50 percent" each place it appears.

\* \* \* \* \*

(3) *Special rule for dividends.* Solely for purposes of dividend payments between controlled foreign corporations in taxable years beginning after December 31, 2000, two controlled foreign corporations shall be considered related look-through entities if the same United States shareholder owns, directly or indirectly, at least 10 percent of the total voting power of all classes of stock of each foreign corporation. Taxpayers may choose to apply this paragraph (i)(3) in taxable years beginning after December 31, 1991, provided that appropriate adjustments are made to eliminate any double benefit arising from the application of this paragraph (i)(3) to taxable years that are not open for assessment.

(4) *Examples.* \* \* \*

*Example 1.* P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. S owns 40 percent of the stock of T, a Country X corporation that is a controlled foreign corporation. The remaining 60 percent of the stock of T is owned by V, a domestic corporation. The percentages of value and voting power of T owned by S and V correspond to their percentages of stock ownership. T owns 40 percent (by vote and value) of the stock of U, a Country Z corporation that is a controlled foreign corporation. The remaining 60 percent of U is owned by unrelated U.S. persons. U earns exclusively general limitation non-subpart F income. In 2001, U makes an interest payment of \$100 to T. Look-through principles do not apply because T and U are not related look-through entities under paragraph (i)(1) of this section (because T does not own more than 50 percent of the voting power or value of U). The interest is passive income to T, and is subpart F income to P and V. Under paragraph (c)(1) of this section, look-through principles determine P and V's characterization of the subpart F inclusion from T. P and V therefore must characterize the inclusion as passive income.

*Example 2.* The facts are the same as in *Example 1* except that instead of a \$100 interest payment, U pays a \$50 dividend to T in 2001. P and V each own, directly or indirectly, more than 10 percent of the voting power of all classes of stock of both T and U. Pursuant to paragraph (i)(3) of this section, for purposes of applying this section to the dividend from U to T, U and T are treated as related look-through entities. Therefore, look-through principles apply to characterize the dividend income as general limitation income to T. The dividend is subpart F income of T that is taxable to P and V. The subpart F inclusions of P and V are also subject to look-through principles, under paragraph (c)(1) of this section, and are characterized as general limitation income to P and V because the income is general limitation income of T.

*Example 3.* The facts are the same as in *Example 1*, except that U pays both a \$100 interest payment and a \$50 dividend to T, and T owns 80 percent (by vote and value) of U. Under paragraph (i)(1) of this section, T and U are related look-through entities, because T owns more than 50 percent (by vote and value) of U. Therefore, look-through principles apply to both the interest and dividend income paid or accrued by U to T, and T treats both types of income as general limitation income. Under paragraph (c)(1) of this section, P and V apply look-through principles to the resulting subpart F inclusions, which therefore are also general limitation income to P and V.

\* \* \* \* \*

(m) \* \* \* (1) \* \* \* For purposes of determining the portion of a dividend paid or accrued (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) by a controlled foreign corporation that is treated as from sources within the United States under section 904(g)(4), the rules in paragraph (m)(4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951(a)(1)(A) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904(g)(2), the rules in paragraph (m)(5) of this section apply. \* \* \*

\* \* \* \* \*

(4) \* \* \* (i) \* \* \* Any dividend or distribution treated as a dividend under this section (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation in that separate category.

\* \* \* \* \*

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

Approved December 13, 2000.

Jonathan Talisman,  
Acting Assistant Secretary  
(Tax Policy).

(Filed by the Office of the Federal Register on December 29, 2000, 8:45 a.m., and published in the



## Section 6302.—Mode or Time of Collection

26 CFR 301.6302–1T: Use of Federal Reserve banks after December 31, 2000.

T.D. 8918

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

#### Removal of Federal Reserve Banks as Federal Depositaries.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations

SUMMARY: This document contains temporary regulations relating to the deposit of Federal taxes pursuant to section 6302 of the Internal Revenue Code. The regulations remove Federal Reserve banks as authorized depositaries for Federal tax deposits. The regulations affect taxpayers that make Federal tax deposits using paper Federal Tax Deposit (FTD) coupons (Form 8109) at Federal Reserve banks.

DATES: *Effective Date:* These regulations are effective December 26, 2000.

*Applicability Date:* These regulations apply to deposits made after December 31, 2000.

FOR FURTHER INFORMATION CONTACT: Brinton T. Warren (202) 622-4940 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background and Explanation of Provisions

This document contains amendments to the Procedure and Administration Regulations (26 CFR part 301) relating to Federal tax deposits under section 6302(c) of the Internal Revenue Code (Code). Section 6302(c) provides that the Secretary may authorize Federal Reserve banks, and incorporated banks, trust companies, domestic building and loan associations, or credit unions that are depositaries or financial agents of the United States, to receive any tax imposed

under the internal revenue laws, in such manner, at such times, and under such conditions as the Secretary may prescribe. Pursuant to this authority, various regulations provide that Federal Reserve banks, as well as other authorized financial institutions, may receive certain Federal tax deposits.

In cooperation with the Treasury Department's Financial Management Service (FMS), the Federal Reserve System has been streamlining its Treasury Tax and Loan (TT&L) Operation to respond to the fact that the overwhelming majority of Federal Tax Deposits (FTDs) are now received electronically. The widespread adoption of electronic deposits by taxpayers is an important aspect of improving the efficiency, reliability, and cost-effectiveness of the Treasury Department's financial management. In general, compared to the universe of all tax deposits, the percentage of FTDs made with paper coupons has significantly declined. FTDs made with paper coupons at Federal Reserve banks now constitute only a tiny percentage of all tax deposits. For example, in Fiscal Year 1999, of the approximately 100 million Federal tax deposits, made by paper coupon and electronically, only about 270,000, or less than one half of one percent, were paper coupons presented at Federal Reserve banks. Additionally, the number of paper coupons presented at Federal Reserve banks has declined over twenty-five percent since 1997.

The Treasury Department has developed an array of other deposit options that are more convenient for taxpayers to use, and more economical to process, than deposits with Federal Reserve banks. For example, taxpayers may use their touch tone telephone or personal computer to make deposits 24 hours a day through the Electronic Federal Tax Payment System (EFTPS). For those taxpayers who still prefer paper coupons over electronic deposits, there are now more than 10,000 financial institutions nationwide that are designated as TT&L depositaries where taxpayers may make FTD deposits using paper coupons.

In response to the declining number of deposits being made with paper coupons at Federal Reserve banks, the Federal Reserve Bank of St. Louis was selected, effective May 1, 2000, to serve as the only

Federal Reserve bank accepting FTDs. Even after this consolidation, however, it is no longer cost-effective for the Federal Reserve bank in St. Louis to process the small number of paper coupons it receives annually. Accordingly, these temporary regulations remove all Federal Reserve banks as depositaries for Federal taxes. To mitigate any difficulties for those taxpayers who still do not wish to use the deposit alternatives discussed above, the Treasury Department has authorized a financial agent to receive and process FTD payments through the mail, thereby maintaining a mail-in alternative for taxpayers who do not have an account with an authorized financial institution and who do not wish to use EFTPS. The address for this mail-in alternative is Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, Missouri, 63197. The IRS is also issuing proposed regulations that remove Federal Reserve banks as depositaries of Federal taxes. See the notice of proposed rule-making on this subject (REG-107176-00) on page 428 of this Bulletin.

#### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Drafting Information

The principal author of these regulations is Brinton T. Warren of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

## Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 301.6302-1T is added to read as follows:

### *§301.6302-1T Use of Federal Reserve banks after December 31, 2000*

Federal Reserve banks are not authorized depositaries for Federal tax deposits made after December 31, 2000.

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

Approved December 6, 2000.

Jonathan Talisman,  
*Acting Assistant Secretary  
for Tax Policy.*

(Filed by the Office of the Federal Register on December 22, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 26, 2000, 65 F.R. 81356)

## Part III. Administrative, Procedural, and Miscellaneous

### Reporting of Gross Proceeds Payments to Attorneys

#### Notice 2001-7

This notice informs taxpayers that the Internal Revenue Service intends to further delay the effective date of the regulations proposed under § 6045(f) of the Internal Revenue Code (relating to the reporting of payments of gross proceeds to attorneys). Under this extension, the rules in § 1.6045-5 will apply to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the Federal Register.

Section 1021 of the Taxpayer Relief Act of 1997, 1997-4 (Vol. 1) C.B. 1, 136, added § 6045(f) of the Code, which requires information reporting for payments made in the course of a trade or business to attorneys in connection with legal services (whether or not such services are performed for the payor). Section 6045(f) applies to payments made after December 31, 1997. The notice of proposed rulemaking (NPRM) under § 6045(f) was published in the Federal Register on May 21, 1999 (64 F.R. 27730), 1999-1 C.B. 1193. Section 1.6045-5(h) of the proposed Income Tax Regulations provides that the rules in § 1.6045-5 apply to payments made after December 31, 1999. However, Notice 99-53, 1999-2 C.B. 565, extended the effective date of § 1.6045-5 to payments made after December 31, 2000.

Because the Service is continuing to study the many comments regarding the NPRM under § 6045(f), the Service intends to further delay the effective date of § 1.6045-5. Accordingly, when finalized, the rules in § 1.6045-5 will apply to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the Federal Register. Nevertheless, payments of gross proceeds to attorneys made after December 31, 1997, are and continue to be reportable on Form 1099-MISC pursuant to § 6045(f); only the effective date of the regulations that interpret § 6045(f) will be delayed. Taxpayers may continue to rely on the NPRM as a safe harbor providing a rea-

sonable interpretation of the statute.

#### EFFECT OTHER DOCUMENTS

Notice 99-53 is modified, and as modified, is superseded.

#### DRAFTING INFORMATION

The principal author of this notice is Sara Paige Shepherd of the Office of the Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice). For further information regarding this notice contact Ms. Shepherd at (202) 622-4910 (not a toll-free number).

### Information Reporting for Discharges of Indebtedness

#### Notice 2001-8

#### PURPOSE

This notice extends the suspension of penalties under §§ 6721 and 6722 of the Internal Revenue Code provided by Notice 2000-22, 2000-16 I.R.B. 902 (April 17, 2000), for certain organizations newly subject to § 6050P (that is, those organizations a significant trade or business of which is the lending of money and that are not otherwise described in § 6050P(c)(1) or (2)). Under this notice, penalties will not be imposed on such an organization for failure to file information returns under § 6050P for any discharge of indebtedness that occurs prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued.

#### BACKGROUND

Generally, § 6050P(a) requires applicable entities that are subject to that section to file returns with the Service, and to provide statements to persons whose names are required to be shown on the returns ("payees"), setting forth certain information regarding discharges of indebtedness of \$600 or more. Sections 6721 and 6722 impose penalties for failure to file correct information returns or to provide correct payee statements, respectively, including those required under § 6050P.

Section 533(a) of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860, 1931 (1999) ("the Act"), amended § 6050P of the Code by expanding the types of entities that are required to report discharges of indebtedness to include any organization "a significant trade or business of which is the lending of money." The Act was signed into law on December 17, 1999. Section 533(a) was made effective for discharges of indebtedness occurring after December 31, 1999. Notice 2000-22 suspended penalties for failures to file information returns or to furnish payee statements for discharges of indebtedness by these newly included organizations occurring prior to January 1, 2001.

#### PENALTY SUSPENSION

The Service recognizes that, in the absence of published guidance regarding the new statutory provision, many organizations potentially included within the reporting provisions of § 6050P by the Act are unable to determine whether they are in fact subject to the new reporting provisions. Furthermore, sufficient time is necessary after guidance is issued for these affected organizations to establish recordkeeping systems needed to capture the information required to be reported under § 6050P. Therefore, the Service will not impose penalties on these organizations for failure to comply with the requirements of § 6050P for discharges of indebtedness occurring prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued.

This notice does not suspend penalties for any organization that was already subject to § 6050P prior to its amendment by the Act.

#### EFFECT ON OTHER DOCUMENTS

Notice 2000-22 is modified, and, as modified, is superseded.

#### DRAFTING INFORMATION

The principal author of this notice is Sharon L. Hall of the Office of Assistant Chief Counsel, Income Tax and Accounting. For further information regarding this notice, contact Ms. Hall at (202) 622-4930 (not a toll-free call).

# Extension of Relief Relating to Application of Nondiscrimination Rules for Certain Governmental Plans and Church Plans

Notice 2001-9

## I. PURPOSE

This notice provides relief from the application of the nondiscrimination requirements of the Internal Revenue Code for certain governmental and church plans.

In particular, this notice provides that certain governmental plans shall be deemed to satisfy § 401(a)(4), 401(a)(26), 401(k)(3), and 401(m) of the Code until the first day of the first plan year beginning on or after January 1, 2002. In accordance with this relief, the regulations relating to these provisions do not apply until plan years beginning after that date. This relief is available with respect to governmental plans within the meaning of § 414(d) other than plans of State and local governments or political subdivisions, agencies or instrumentalities thereof.

In addition, this notice extends, until the first day of the first plan year beginning on or after January 1, 2002, the effective date of certain nondiscrimination regulations for nonelecting church plans. Specifically, this notice extends the effective date of the regulations under §§ 401(a)(4), 401(a)(5), 401(l), and 414(s) of the Internal Revenue Code.

## II. BACKGROUND

### A. Governmental Plans

Section 414(d) of the Code provides that the term “governmental plan” means a plan established and maintained for its employees by the government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. The term “governmental plan” also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (the “Act”) applies and which is financed by contributions under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669).

Section 1505 of the Taxpayer Relief Act of 1997 (“TRA ‘97”) generally provides

that the nondiscrimination rules do not apply to State and local governmental plans. In particular, § 1505 amended the Code to provide that § 401(a)(3), 401(a)(4), and 401(a)(26) shall not apply to such plans. Section 1505 of TRA ‘97 amended § 401(k) of the Code to provide that State and local governmental plans shall be treated as meeting the requirements of § 401(k)(3). In addition, § 1505(a)(3) of TRA ‘97 amended § 410(c) of the Code to provide that governmental plans shall be treated as meeting the requirements of § 410 for purposes of § 401(a). This amendment to § 410(c), by its terms, is not limited to State and local governmental plans but applies to all governmental plans within the meaning of § 414(d).

Notice 99-40, 1999-35 I.R.B. 324, provided that governmental plans, other than plans maintained by State or local governments or political subdivisions or instrumentalities thereof, would be deemed to satisfy § 401(a)(4), 401(a)(26), 401(k)(3), and 401(m) of the Internal Revenue Code until the first day of the first plan year beginning on or after January 1, 2001. The notice also provided that the regulations relating to these provisions would not apply until plan years beginning on or after that date.

### B. Church Plans

Section 414(e)(1) of the Code provides in general that the term “church plan” means a plan established and maintained for its employees (and their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under § 501. Pursuant to § 410(d), a church or convention or association of churches which maintains any church plan may make an election under § 410(d) to have certain Code provisions relating to participation, vesting, and funding, etc., apply to such church plan (an “electing church plan”) as if such provisions did not contain an exclusion for church plans. A church plan for which such an election has not been made (a “nonelecting church plan”) is not subject to these provisions.

Notice 98-39, 1998-2 C.B. 205, provided that the regulations under §§ 401(a)(4), 401(a)(5), 401(l) and 414(s) apply for nonelecting church plans in plan years beginning on or after January 1, 2001. For plan years beginning before that effective date, nonelecting church

plans must be operated in accordance with a reasonable, good faith interpretation of these statutory provisions.

## III. EXTENSION OF RELIEF RELATING TO APPLICATION OF NONDISCRIMINATION RULES FOR CERTAIN GOVERNMENTAL PLANS

Under the relief provided by this notice, governmental plans within the meaning of § 414(d), other than those maintained by State or local governments or political subdivisions, agencies or instrumentalities thereof, shall be treated as satisfying the requirements of § 401(a)(4), 401(a)(26), 401(k)(3), and 401(m) until the first plan year beginning on or after January 1, 2002. In accordance with this relief, the regulations under §§ 401(a)(4), 401(a)(26), 401(m), 410(b) and 414(s), and the regulations implementing § 401(k)(3), apply to governmental plans described in this part only for plan years beginning on or after January 1, 2002.

## IV. EXTENSION OF EFFECTIVE DATE OF NONDISCRIMINATION REGULATIONS FOR NONELECTING CHURCH PLANS

Under the extension provided by this notice, the regulations under §§ 401(a)(4), 401(a)(5), 401(l), and 414(s) apply to nonelecting church plans only for plan years beginning on or after January 1, 2002. For plan years beginning before this extended effective date, nonelecting church plans must be operated in accordance with a reasonable, good faith interpretation of these statutory provisions.

## V. EFFECT ON OTHER DOCUMENTS

Notices 98-39 and 99-40 are modified.

## DRAFTING INFORMATION

The principal author of this notice is Diane S. Bloom of the Employee Plans Division. For further information regarding this notice, please contact the Employee Plans Division’s taxpayer assistance telephone service at (202) 283-9516 or (202) 283-9517, between the hours of 1:30 p.m. and 3:30 p.m. Eastern Time, Monday through Thursday. Ms. Bloom may be reached at (202) 622-6214. These telephone numbers are not toll-free.



## **Publication 1245 (Rev.1-2001)**

### **Specifications for Filing Form W-4, Employee's Withholding Allowance Certificate, Magnetically or Electronically**

**Rev. Proc. 2001-16**

**Reprinted from IR Bulletin 2001-4 dated, January 22, 2001 (and containing copies of Forms 4419, 6466, 6467, and Notice 1027 for taxpayers' use)**

**IRS/MCC will no longer return problem media in need of replacement beginning in Tax Year 2001 filed in calendar year 2002. See Part A, Sec. 2 .04 for details. In addition, beginning in calendar year 2003 for Tax Year 2002, IRS/MCC will no longer accept 9 track tapes for the filing of Forms W-4. See Part B, Sec. 2.**

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## PART A. GENERAL

### SEC. 1. PURPOSE

**.01** The purpose of this revenue procedure is to update Rev. Proc. 99-47, 1999-49 I.R.B. 624, issued December 6, 1999, (IRS Pub.1245 Rev. 03-2000), which outlines the requirements and conditions for submitting certain Forms W-4, Employee's Withholding Allowance Certificate, magnetically or electronically to the Internal Revenue Service (IRS), Martinsburg Computing Center (MCC). Rev. Proc. 99-47, (IRS Publication 1245 Rev. 03-2000), is superseded by Rev. Proc. 2001-16, (IRS Pub. 1245 Rev. 1-2001).

**.02** Revenue procedures are generally revised to reflect legislative and form changes. Comments concerning this revenue procedure or suggestions for making it more helpful can be addressed to Internal Revenue Service, Martinsburg Computing Center, ATTN: IRB Information Support Section, 230 Murall Dr, Kearneysville, WV 25430. Use this revenue procedure to file Forms W-4 submitted for the quarter ending March 31, 2001, and for all subsequent filings.

**.03** The following revenue procedures and publications provide more detailed filing procedures for certain information returns and can be obtained by contacting any IRS office or by calling 1-800-829-3676:

- (a) Instructions for Forms 1099, 1098, 5498, and W-2G providing specific instructions on completing and submitting information returns to IRS.
- (b) Rev. Proc. 84-33, 1984-1 C.B. 502, regarding the optional method for agents to report and deposit backup withholding.
- (c) Publication 1179, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W-2G.
- (d) Publication 1220, Specifications for Filing Form 1098, 1099, 5498, and W-2G Magnetically or Electronically.
- (e) Publication 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, Magnetically or Electronically.
- (f) Publication 1187, Specifications for Filing Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically.

**.04** Refer to Part A, Sec. 10, for definitions of terms used in this publication.

### SEC. 2. NATURE OF CHANGES

Numerous editorial changes have been made to the revenue procedure. Please read the publication carefully and in its entirety before attempting to prepare your magnetic/electronic file for submission. Major changes are italicized. The changes are as follows:

**.01 Part B, Sec. 2, Beginning in calendar year 2003 for Tax Year 2003, IRS/MCC will no longer accept 9 track tapes for the filing of Forms W-4. This restriction will apply to fourth quarter 2002 Forms W-4 filed in January 2003. See Part B, Sec. 2.**

**.02** Electronic filing specifications are in Part C. Numerous changes have been made to these instructions. Please read this part carefully.

**.03** Part D is new and contains information on contacting IRS/MCC in a centralized location within the publication.

**.04 Beginning in calendar year 2002 for Tax Year 2001, IRS/MCC will no longer return problem media in need of replacement.** Filers will continue to receive a tracking form, listing and letter detailing the reason(s) their media could not be processed. Filers will be expected to send in replacement media within the prescribed time frame. This makes it **imperative** that filers maintain backup copies and/or recreate capabilities for their information return files.

### SEC. 3. WHERE TO FILE AND HOW TO CONTACT THE IRS, MARTINSBURG COMPUTING CENTER

**.01** All Forms W-4 filed magnetically or electronically are processed at IRS/MCC. Magnetic media containing Forms W-4 is to be sent to the following address:

IRS-Martinsburg Computing Center  
Information Reporting Program  
*240 Murall Drive*  
Kearneysville WV 25430

**.02** Requests for paper forms and publications can be made by calling the "Forms Only Number" listed in your local telephone directory or by calling the IRS toll-free number **1-800-TAX-FORM (1-800-829-3676)**.

**.03** Questions pertaining to magnetic media/electronic filing of Forms W-2 **must** be directed to the Social Security Administration (SSA). Filers can call 1-800-SSA-6270 to obtain the phone number of the SSA Employer Service Liaison Officer for their area.

**.04** A taxpayer or authorized representative may request a copy of a tax return or a Form W-2 filed with a return by submitting

Form 4506, Request for Copy or Transcript of Tax Form, to IRS. This form may be obtained by **calling 1-800-TAX-FORM (1-800-829-3676)**.

**.05** The IRS/MCC Call Site, located in Kearneysville, WV, provides service to the payer/employer community (financial institutions, employers, and other transmitters of information returns). The IRS/MCC Call Site answers questions concerning tax law and the magnetic/electronic filing of questionable Forms W-4 as well as information returns (Forms 1096, 1098, 1099, 5498, 5498-MSA, 8027, W-2G, and 1042-S), inquiries dealing with backup withholding due to missing and incorrect taxpayer identification numbers and questions concerning paper filing of Forms W-2 and W-3. Recipients of information returns (payees) should continue to contact 1-800-829-1040 or other numbers specified in the tax return instructions with any questions on how to report information returns.

The Call Site accepts calls from all areas of the country. The number to call is **304-263-8700** or Telecommunications Device for the **Deaf (TDD) 304-267-3367**. These are toll calls. The Call Site is in operation throughout the year to handle the questions of payers, transmitters, and employers. Due to the high demand for assistance at the end of January and February, it is advisable to call as soon as possible to avoid these peak filing seasons.

**.06** Telephone inquiries may be made Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern time. The telephone numbers for magnetic media/electronic inquiries or electronic submissions are:

**304-263-8700 - Call Site**

**304-262-2400 - Electronic Filing**

**304-267-3367 - TDD (Telecommunication Device for the Deaf)**

**304-264-5602 - Fax Machine**

**(These are not toll-free telephone numbers.)**

**TO OBTAIN FORMS & PUBLICATIONS CALL:  
1-800-TAX-FORM (1-800-829-3676)**

**TO OBTAIN FORMS & PUBLICATIONS VIA INTERNET:**

**[www.irs.gov](http://www.irs.gov)**

#### **SEC. 4. FILING REQUIREMENT**

**.01** Employers are required to send to the IRS quarterly, copies of all Forms W-4 received during the quarter from employees still employed at the end of that quarter who claim:

- (a) More than 10 withholding allowances, or
- (b) Exempt status and are expected to earn more than \$200 a week.

**.02** Employers are not required to send other Forms W-4 unless notified by IRS in writing to do so.

**.03** Employers may submit all information magnetically or electronically; a combination of magnetic/electronic files and paper documents is acceptable, provided there are no duplications or omissions of documents. However, magnetic/electronic filing is preferred and strongly encouraged.

**.04** A Form W-4 with a written statement attached from the employee must be submitted on paper, not on magnetic media. The employer may send paper Forms W-4 each quarter with their paper Form 941. If the employer submits the paper Forms W-4 at any time other than quarterly, a cover letter must be submitted giving the employer's name, address, employer identification number (EIN), and the number of Forms W-4 included.

**NOTE: MCC DOES NOT PROCESS PAPER RETURNS. PAPER RETURNS MUST BE FILED WITH THE APPROPRIATE SERVICE CENTER. SEE FORM 941 INSTRUCTIONS FOR THE APPROPRIATE SERVICE CENTER.**

#### **SEC. 5. FORM 4419, APPLICATION FOR FILING INFORMATION RETURNS MAGNETICALLY/ELECTRONICALLY**

**.01** Employers, or their transmitters, who wish to file Forms W-4 magnetically or electronically, must first submit a Form 4419, Application for Filing Information Returns Magnetically/Electronically. Instructions for its completion are on the reverse of the form.

**.02** Magnetic/electronic files may not be submitted to IRS/MCC until authorization to file is received by the employer. Requests will be approved or disapproved within 30 days of receipt.

**.03** Applications of only those employers or transmitters whose equipment meets the specifications in Part B, Sec. 2, 3, 4, 5 or 6 will be approved.

**.04** Once authorization to file has been granted, a five-character alpha/numeric Transmitter Control Code (TCC) will be assigned. Approval will continue in effect in succeeding years provided the requirements of the current revenue procedure are met and there are no equipment changes by the employer or transmitter. Although a TCC may have already been assigned to a transmitter for the filing of information returns, the Form W-4 requires a separate TCC. This TCC must appear on all transmittal forms submitted with



magnetic/electronic files, as well as other correspondence. The TCC must also be coded into positions 319-323 of the Form W-4 record. (See Part B, Sec. 7.)

**.05** A new application (Forms 4419) is required if

- (a) You discontinue filing magnetically/electronically for two years, in which case your TCC may have been reassigned. You may call IRS/MCC to verify if your TCC is still valid.
- (b) You previously used a service bureau with its own TCC, but you now have computer equipment compatible with that of IRS, in which case you must request your own TCC.

## SEC. 6. DUE DATES

**.01** Magnetic/electronic reporting of Forms W-4 to IRS must be at least quarterly (monthly reporting is encouraged). The following are the quarterly due dates:

<u>Period Covered</u>	<u>Due Date</u>
January 1 thru March 31 .....	April 30
April 1 thru June 30 .....	July 31
July 1 thru September 30 .....	October 31
October 1 thru December 31 .....	January 31

**.02** If any due date falls on a Saturday, Sunday, or legal holiday, the Forms W-4 are considered timely if they are filed on the next day that is not a Saturday, Sunday, or legal holiday.

## SEC. 7. FILING FORMS W-4 MAGNETICALLY/ELECTRONICALLY

**.01** A Magnetic Media/Electronic Reporting Package, which includes the current revenue procedure and the necessary transmittal forms, will be mailed to approved filers each year.

**.02** If the employer chooses to file magnetically/electronically, then a Form 6466, Transmittal of Forms W-4 Reported Magnetically/Electronically, must be sent to the IRS/MCC as prescribed in Part A, Sec. 3.

**.03** Form 6466 MUST be signed by the employer or the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), on behalf of the employer if the agent has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law and adds the caption "FOR: (name of employer)."

**.04** Although a duly authorized agent signs the affidavit, the employer(s) is held responsible for the accuracy of the Forms W-4 filed magnetically or electronically.

**.05 DO NOT REPORT THE SAME INFORMATION ON PAPER DOCUMENTS THAT YOU REPORT MAGNETICALLY/ELECTRONICALLY.** If you report part of your returns on paper and part magnetically or electronically, be sure that duplicate returns are not included on both.

**.06** Before submitting your magnetic/electronic file, include the following:

- (a) A signed Form 6466, Transmittal of Forms W-4 Reported Magnetically/Electronically along with a Form 6467, Transmittal of Forms W-4 Reported Magnetically/Electronically(Continuation), if you submit data for multiple employers. These forms must be mailed or faxed the same day electronic files are submitted.
- (b) Your media (tape, diskette, or cartridge) with an external identifying label. Notice 1027 describes the information which should be included on this self-prepared label.
- (c) On the outside of the shipping container, affix the label IRB Special Projects. This label is included in the publication.

**.07** IRS/MCC will not return filers' magnetic media after it has been successfully processed. Should filers wish to know if their media was received by IRS/MCC, a delivery service that provides certification of delivery is recommended.

**.08** IRS cannot accept any Cash-On-Delivery (COD) or Charged-to-IRS shipments of reportable tax information that an individual or organization is legally required to file. Because of the high volume of data received and shipping cost involved, special shipping containers will not be returned.

**.09** Use this record format and processing capabilities to file Forms W-4 submitted for the quarter ending March 31, 2001, and for all subsequent filings.

## SEC. 8. REPLACEMENT FILES

**THE MAGNETIC MEDIA/ELECTRONIC SPECIFICATIONS CONTAINED IN PART B OF THIS REVENUE PROCEDURE MUST BE STRICTLY ADHERED TO.** If files are not processable, they will be returned to you for replacement and resubmission, or submission of paper Forms W-4. Replacement files must be resubmitted to IRS/MCC within 45 days of the date of the enclosed letter. The media should be identified as replacement data by writing, typing or printing "Magnetic Media Replacement" on the external label used on the magnetic media and marking the replacement box on the Form 6466. If filing electronically, you should choose replacement when asked for the type of submission to identify a replacement file before transmission begins.

**Note: BEGINNING IN CALENDAR YEAR 2002 FOR TAX YEAR 2001, IRS/MCC WILL NO LONGER RETURN PROBLEM MEDIA IN NEED OF REPLACEMENT.** Filers will continue to receive a tracking form, listing and letter detailing the rea-

son(s) their media could not be processed. Filers will be expected to send in replacement media within the prescribed time frame. This makes it **imperative** that filers maintain backup copies and/or recreate capabilities for their information return files.

## SEC. 9. EFFECT ON PAPER DOCUMENTS

**.01** Magnetic/electronic reporting to IRS eliminates the need to submit copies of paper Forms W-4.

**.02** If part of the Forms W-4 are reported magnetically/electronically and the remainder are reported on paper forms, the paper Forms W-4 must be mailed to the appropriate service center.

## SEC. 10. DEFINITION OF TERMS

Employer	Generally, an employer is a person or organization for whom a worker performs a service as an employee. The employer has the right to direct and control the worker. A person or organization paying wages to a former employee after the work ends is also considered an employer.
Employee	One who performs services for an employer.
EIN	Employer Identification Number that has been assigned to the employer by IRS.
File	For purposes of this procedure, a file consists of all magnetic/electronic records submitted by an employer or transmitter.
Special Character	Any character that is not a numeric, an alpha or a blank.
Social Security Number (SSN)	Social Security Number (SSN) that has been assigned to the employee by the Social Security Administration.
Transmitter	Person or organization preparing and/or submitting magnetic/electronic file(s).
Transmitter Control Code (TCC)	A five-character alpha/numeric number assigned by IRS to the transmitter prior to actual filing magnetically/electronically. This number is inserted in Positions 319-323 of your files and must be present before the file can be processed. An application Form 4419 must be filed with IRS to receive this number.

## PART B. MAGNETIC MEDIA SPECIFICATIONS

### SEC. 1. GENERAL

**.01** The specifications contained in this part of the revenue procedure define the required format and content of the records to be included in the magnetic/electronic file. Use this revenue procedure to file Forms W-4 submitted for the quarter ending March 31, 2001 and all subsequent filings.

**.02** An external label must appear on each tape, tape cartridge and diskette submitted. Notice 1027 details what information must be on the label. The diskettes used must be MS/DOS compatible.

### SEC. 2. TAPE SPECIFICATIONS

**Note:** *Beginning in calendar year 2003 for Tax Year 2003, IRS/MCC will no longer accept 9 track tapes for the filing of Forms W-4. Fourth quarter 2002 Forms W-4 filed by January 31, 2003, can NOT be submitted on 9 track tape.*

**.01** IRS/MCC can process most magnetic tape files if the following specifications are followed:

- (a) 9-track EBCDIC (Extended Binary Coded Decimal Interchange Code) with
  - (1) Odd parity
  - (2) Recording density—1600 or 6250 BPI
  - (3) If you use UNISYS Series 1100, you must submit an interchange tape.
- (b) 9-track ASCII (American Standard Coded Information Interchange) with:

- (1) Odd parity
- (2) Recording density—1600 or 6250 BPI
- .02 All tape files must have the following characteristics:
  - (a) 0.5 inch (12.7 mm) wide, computer grade magnetic tape,
  - (b) Tape thickness: 1.0 or 1.5 mils,
  - (c) Reel diameter: 10.5 inch (26.67 cm), 8.5 inch (21.59 cm), or 7 inch (17.78 cm) and
  - (d) Reel of tape up to 2400 feet (731.52 m).
- .03 All records, including Header and Trailer Labels (if used) must be transmitted using the same density.
- .04 The tape records defined in this revenue procedure may be blocked subject to the following:
  - (a) A block must not exceed 32,550 tape positions.
  - (b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. **Do not pad a block with blanks.**
  - (c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 350.
  - (d) All data records are a fixed record length of 350 positions and may not span blocks.
- .05 Labeled or unlabeled tapes may be submitted.
- .06 For the purposes of this revenue procedure the following must be used:
 

Tape Mark:

  - (a) Used to signify the physical end of the recording on tape.
  - (b) For even parity, use BCD configuration 001111(8421).
  - (c) May follow the header label and precede and/or follow the trailer label.
- .07 Do not submit an employee Form W-4 record without the required employer identification information. Every record must contain both employee and employer data.

### SEC. 3. TAPE CARTRIDGE SPECIFICATIONS

- .01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:
  - (a) Must be IBM 3480, 3490, 3490E, 3590, 3590E or AS400 compatible.
  - (b) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:
    - (1) Tape cartridges will be 1/2-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.
    - (2) Magnetic tape will be chromium dioxide particle based 1/2-inch tape.
    - (3) Cartridges must be 18-track or 36-track parallel (See Note).
    - (4) Cartridges will contain 37,871 CPI (characters per inch ) or 75,742 CPI.
    - (5) Mode will be full function.
    - (6) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.
    - (7) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used.
- .02 The tape cartridge records defined in this revenue procedure may be blocked subject to the following:
  - (a) A block must not exceed 32,550 tape positions.
  - (b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. Do not pad a block with blanks.
  - (c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 350.
  - (d) Records may not span blocks.
- .03 Tape cartridges may be labeled or unlabeled.
- .04 For the purposes of this revenue procedure, the following must be used:
 

Tape Mark:

  - (a) Used to signify the physical end of the recording on tape.
  - (b) For even parity, use BCD configuration 001111(8421).
  - (c) May follow the header label and precede and/or follow the trailer label.

**Note:** Filers should indicate on the external media label and transmittal Form 6466 whether the cartridge is 36-track or 18-track.



## SEC. 4. 8MM, 4MM AND QUARTER-INCH CARTRIDGE SPECIFICATIONS

**.01** In most instances, IRS/MCC can process 8mm tape cartridges that meet the following specifications:

(a) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

- (1) Created from an AS400 operating system only.
- (2) 8mm (.315-inch) tape cartridges will be 2 1/2-inch by 3 3/4-inch.
- (3) The 8mm tape cartridges must meet the following specifications:

Tracks	Density	Capacity
1	20 (43245 BPI)	2.3 Gb
1	21 (45434 BPI)	5 Gb

- (4) Mode will be full function.
- (5) Compressed data is not acceptable.
- (6) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.

**.02** The 8mm (.315-inch) tape cartridge records defined in this revenue procedure may be blocked subject to the following:

- (a) A block must not exceed 32,550 tape positions.
- (b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. **Do not pad a block with blanks.**
- (c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 350.
- (d) Various COPY commands have been successful, however, the SAVE OBJECT COMMAND is not acceptable.
- (e) Records may not span blocks.

**.03** For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. QWFTAX may be used as a suggested filename.

**.04** For the purposes of this revenue procedure, the following must be used:

Tape Mark:

- (a) Used to signify the physical end of the recording on tape.
- (b) For even parity, use BCD configuration 001111(8421).
- (c) May follow the header label and precede and/or follow the trailer label.

**.05** IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tape-mark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

**.06** 4mm (.157-inch) cassettes are acceptable with the following specifications:

- (a) 4 mm cassettes will be 2 1/4-inch by 3-inch.
- (b) The tracks are 1 (one).
- (c) The density is 19 (61000 BPI).
- (d) The typical capacity is DDS (DAT data storage) at 1.3 Gb or 2 Gb, or DDS-2 at 4Gb.
- (e) The general specifications for 8mm cartridges will also apply to the 4mm cassettes.

**.07** Various Quarter Inch Cartridges (QIC) (1/4-inch) are also acceptable.

- (a) QIC cartridges will be 4" by 6".
- (b) QIC cartridges must meet the following specifications:

Size	Tracks	Density	Capacity
QIC-24	8/9	5 (8000 BPI)	45Mb or 60Mb
QIC-120	15	15 (10000 BPI)	120Mb or 200Mb
QIC-150	18	16 (10000 BPI)	150Mb or 250Mb
QIC-525	26	17 (16000 BPI)	525Mb
QIC-1000	30	21 (36000 BPI)	1Gb
QIC-2Gb	42	34 (40640 BPI)	2Gb

☛ **Note: Advanced Metal Evaporated (AME) cartridges are not acceptable.**

## SEC. 5. 3 1/2-INCH DISKETTE SPECIFICATIONS

**.01** To be compatible, a diskette file must meet the following specifications:

- (a) 3 1/2-inches in diameter.
- (b) Data must be recorded in standard ASCII code.
- (c) Records must be a fixed length of 350 bytes per record.

- (d) Delimiter character commas (,) must not be used.
- (e) Positions 349 and 350 of each record have been reserved for carriage return/line feed (cr/lf) characters.
- (f) Filename of QWFTAX must be used. Do not enter any other data in this field. The extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named QWFTAX.001, the second diskette will be QWFTAX.002, etc.
- (g) A diskette file may consist of multiple diskettes as long as the file naming conventions are adhered to.
- (h) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/Density	Sector Size
1.44 mb	96tpi	hd	512
1.44 mb	135tpi	hd	512
1.2 mb	96tpi	hd	512

**.02** 3 1/2-inch diskettes are only acceptable if they were created using MS/DOS.

## SEC. 6. FORM W-4 RECORD FORMAT AND LAYOUT

**.01** This record is used to identify the employer, the employee, number of allowances, and other information that is reported on the paper Form W-4.

**.02** ALL RECORDS MUST BE A FIXED LENGTH OF 350 POSITIONS.

**.03** Do not begin any record at the end of a block or diskette and continue the same record into the next block or diskette.

### FORM W-4 RECORD FORMAT

Field Position	Field Title	Length	Description and Remarks
1-9	Employee Social Security Number (SSN)	9	REQUIRED. Enter the 9-digit SSN assigned to the employee. DO NOT ENTER HYPHENS or ALPHA CHARACTERS. All zeroes, ones, twos, etc., will have the effect of an incorrect TIN.
10-44	Employee Name Line 1	35	<p>REQUIRED. Enter the name of the employee whose TIN appears in field positions 1-9. Enter the name in the following order: first name, middle name (if present), and surname. (Use initials for the first and middle names where necessary to insure that the entire employee surname fits in the field.) If fewer than 35 characters are used, left-justify and fill unused positions with blanks.</p> <p>(1) A blank must be surrounded by alphas or continued to the end of the field (e.g., ab...b, aba).</p> <p>(2) A hyphen in the first position is to identify an employee with surname only. Hyphens must be surrounded by alphas or numerics and must never occur in the first position of a name unless immediately followed by a caret.</p> <p>(3) A caret is used to define an internal name control. It must immediately precede the employee surname in place of the blank. A second caret is used to separate a suffix from the surname (e.g., JOHN J.&lt;BLACK; BILL&lt;OAK&lt;JR; AMY FERN&lt;BROWN&lt; MD ).</p>

**Note:** The only allowable characters are alphas, blanks, numerics, ampersands, hyphens, and slashes. A minimum of one and a maximum of two carets (<) can be used. Punctuation, such as, periods and commas are not allowed and will cause your file to be returned.

45-79	Employee Name Line 2	35	Optional. This line is designated for an "in care of" (c/o) situation. Left-justify and fill unused positions with blanks. Hyphens and slashes must be
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FORM W-4 RECORD FORMAT

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Field Position	Field Title	Length	Description and Remarks
			surrounded by alphas or numerics; ampersands must be surrounded by blanks; blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).

**Note: The same exceptions apply as set forth in “Employee Name Line 1”; also the use of a percent sign (%) is not valid—use c/o if necessary.**

80–114	Employee Street Address	35	REQUIRED. Enter mailing address of employee. Street address should include number, street, apartment or suite number (or P O Box if mail is not delivered to street address). Left-justify and fill unused positions with blanks. Position 80 must be an alpha or numeric; hyphens and slashes must be surrounded by alphas or numerics; ampersands must be surrounded by blanks; blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).
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**Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the address 210 N. Queen St., Suite #300 must be entered as 210 N Queen St Suite 300.**

115–139	Employee City	25	REQUIRED. Enter the city, town, or post office. If a foreign address, see <b>Note 2</b> . Left-justify and fill unused positions with blanks. Enter APO or FPO, if applicable. Do not enter state and ZIP Code information in this field. Position 115 must be an alpha or numeric; hyphens must be surrounded by alphas or numerics; blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).
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**Note 1: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens, and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the city St. Louis must be entered as St Louis.**

**Note 2: For foreign addresses, you may use the 25 position Employee City field to provide the following information: city and country name.**

140–141	Employee State	2	REQUIRED. Enter the two-character location code of employee address--must be one of the following:
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**Note: For foreign addresses, enter xx from table below.**

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FORM W-4 RECORD FORMAT

Field Position	Field Title	Length	Description and Remarks														
Location	Code	Location	Code	Location	Code												
Alabama	AL	Kentucky	KY	Ohio	OH												
Alaska	AK	Louisiana	LA	Oklahoma	OK												
American Samoa	AS	Maine	ME	Oregon	OR												
Arizona	AZ	Marshall Islands	MH	Pennsylvania	PA												
Arkansas	AR	Maryland	MD	Puerto Rico	PR												
California	CA	Massachusetts	MA	Rhode Island	RI												
Colorado	CO	Michigan	MI	South Carolina	SC												
Connecticut	CT	Minnesota	MN	South Dakota	SD												
Delaware	DE	Mississippi	MS	Tennessee	TN												
District of Columbia	DC	Missouri	MO	Texas	TX												
Federated States of Micronesia	FM	Montana	MT	Utah	UT												
Florida	FL	Nebraska	NE	Vermont	VT												
Georgia	GA	Nevada	NV	Virginia	VA												
Guam	GU	New Hampshire	NH	Virgin Islands	VI												
Hawaii	HI	New Jersey	NJ	Washington	WA												
Idaho	ID	New Mexico	NM	West Virginia	WV												
Illinois	IL	New York	NY	Wisconsin	WI												
Indiana	IN	North Carolina	NC	Wyoming	WY												
Iowa	IA	North Dakota	ND	Foreign Address, All Others	XX												
Kansas	KS	Northern Mariana Islands	MP														
142–150	Employee ZIP Code	9	REQUIRED. Enter the valid nine-digit ZIP Code of employee. <b>IF YOU ONLY HAVE FIVE (5) DIGITS AVAILABLE, LEFT-JUSTIFY AND ZERO FILL.</b> Blank fill only if the employee’s ZIP Code is unavailable.														
151	Marital Status	1	REQUIRED. Enter appropriate code from the table below: <table><tr><td><u>Marital Status</u></td><td><u>Code</u></td></tr><tr><td><u>Designated</u></td><td></td></tr><tr><td>Single</td><td>S</td></tr><tr><td>Married</td><td>M</td></tr><tr><td>Married, withhold at single rate</td><td>W</td></tr><tr><td>No marital status designated</td><td>A</td></tr></table>			<u>Marital Status</u>	<u>Code</u>	<u>Designated</u>		Single	S	Married	M	Married, withhold at single rate	W	No marital status designated	A
<u>Marital Status</u>	<u>Code</u>																
<u>Designated</u>																	
Single	S																
Married	M																
Married, withhold at single rate	W																
No marital status designated	A																
152	Exempt Status	1	REQUIRED. Enter “E” if employee claims exempt status; otherwise, enter blank.														
153	BLANK	1	Enter Blank.														
154–156	Allowances	3	REQUIRED. Must be a three (3) digit numeric field corresponding to the number of allowances claimed by employee. (It is necessary to file this Form W-4 with IRS if the number of allowances is more than ten (10) or exempt status is claimed.) Field must be right justified and zero filled. If no entry, or employee claimed exempt status, enter blanks.														

FORM W-4 RECORD FORMAT

Field Position	Field Title	Length	Description and Remarks
157–163	Additional Amount	7	REQUIRED. Enter any additional amount of withholding the employee wants deducted from each pay. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. <b>Do not enter dollar signs, commas, decimal points, or negative numbers.</b> Right-justify and zero fill. If no entry, zero-fill.
164–169	BLANK	6	Enter Blanks.
170–178	Employer Identification Number	9	REQUIRED. The 9-digit EIN assigned to the employer. DO NOT ENTER HYPHENS, ALPHA CHARACTERS. All zeroes, ones, twos, etc., will have the effect of an incorrect TIN.
179–213	Employer Name Line 1	35	REQUIRED. Enter the name of the employer as it appears on employment tax forms (e.g., Form 941). Any extraneous information must be deleted from this name line. Left-justify and fill with blanks. Position 179 must be alpha or numeric; hyphens and slashes must be surrounded by alphas or numerics; blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).

**Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens, and slashes. Punctuation, such as periods and commas, are not allowed and will cause your file to be returned.**

214–247	Employer Name Line 2	34	If the employer name requires more space than is available in Employer Name Line 1, enter the remaining portion of the name in this field. Left-justify and fill with blanks. Position 214 must be alpha or numeric; hyphens must be surrounded by alphas or numerics; blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).
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**Note: The same exceptions apply as set forth in “Employer Name Line 1”; also, the use of a percent sign (%) is not valid—use c/o if necessary.**

248–282	Employer Street	35	REQUIRED. Enter mailing address of employer. Street address should include number, street, apartment, or suite number (or P O Box if mail is not delivered to street address). Left-justify and fill unused positions with blanks. Position 248 must be alpha or numeric; hyphens must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).
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**Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the address 210 N. Queen St., Suite #300 must be entered as 210 N Queen St Suite 300.**

283–307	Employer City	25	REQUIRED. Enter the city, town or post office. Enter APO or FPO if applicable. Do not enter state and ZIP Code information in this field. Position 283 must be alpha or numerics; blanks must be numeric; hyphens must be surrounded by alphas or numerics;
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FORM W-4 RECORD FORMAT

Field Position	Field Title	Length	Description and Remarks
			blanks must be surrounded by alphas or numerics or continued to the end of the field (e.g., ab...b, aba).
<b>Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens, and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the city St. Louis must be entered as St Louis.</b>			
308–309	Employer State Code	2	REQUIRED. Enter location code of employer. Must use abbreviation shown in the location abbreviation table for Employee Location Code (field positions 140-141).
310–318	Employer ZIP Code	9	REQUIRED. Enter the valid nine digit ZIP Code of employer. <b>IF YOU ONLY HAVE FIVE (5) DIGITS AVAILABLE, LEFT-JUSTIFY AND ZERO FILL.</b> Blank fill only if employer's ZIP Code is unavailable.
319–323	Transmitter Control Code	5	REQUIRED. Enter 5-character Transmitter Control Code (TCC) assigned by IRS/MCC.
324–331	Form W-4 Date	8	REQUIRED. Enter date located on signature line Form W-4. If no date entered, generate current system date. Format as YYYYMMDD (e.g., 19991231). Exempt Status Form W-4 Compare "year effective date" on Line 7 to signature date. If year entered on Line 7 is later than signature date, use Form W-4 date as a 01/01 receipt for subsequent calendar year (e.g., Line 7 of Form W-4 shows an exempt status date of 2000 but signature date is 19991031, use 20000101 as Form W-4 date.)
332–348	BLANK	17	Enter Blanks.
349–350	BLANK	2	Enter blanks, or carriage return/line feed (CR/LF) characters.

FORM W-4 RECORD LAYOUT

Employee Social Security Number	Employee Name Line 1	Employee Name Line 2	Employee Street Address	Employee City	
1–9	10–44	45–79	80–114	115–139	
Employee State	Employee Zip Code	Marital Status	Exempt Status	BLANK	Allowances
140–141	142–150	151	152	153	154–156



FORM W-4 RECORD LAYOUT

Additional Amount	BLANK	Employer Identification Number	Employer Name Line 1	Employer Name Line 2
157–163	164–169	170–178	179–213	214–247
Employer Street	Employer City  Line 1	Employer State Code	Employer ZIP Code	Transmitter Control Code
248–282	283–307	308–309	310–318	319–323
Form W-4 Date		BLANK	BLANK or CR/LF	
324–331	332–348	349–350		

## PART C. ELECTRONIC FILING SPECIFICATIONS

### SEC. 1 BACKGROUND

**.01** All electronic filing of information returns are received at IRS/MCC via the FIRE (Filing Information Returns Electronically) System. The FIRE System can be accessed via analog and ISDN BRI connections. The system is designed to support the electronic filing of information returns only. The telephone number for electronic filing is **(1-304-262-2400)**. Publications and forms are no longer available electronically from MCC. Users needing publications and forms will need to download them from the IRS' Web Site at [www.irs.gov](http://www.irs.gov) or order them by calling 1-800-TAX-FORM (1-800-829-3676).

### SEC. 2. ADVANTAGES OF FILING ELECTRONICALLY

Some of the advantages of filing electronically are as follows:

- (1) Results available within 10 workdays as to the acceptability of the data transmitted. It is the filer's responsibility to dial back in and check results.
- (2) Better customer service due to on-line availability of transmitter's files for research purposes.

### SEC. 3. GENERAL

**.01** Electronic filing of Forms W-4, originals, and replacements of information returns is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper submissions, but is not a requirement. Transmitters filing electronically will fulfill the magnetic media requirements for those withholding agents whom are required to file magnetically. It may also be used by withholding agents who are under the filing threshold requirement, but would prefer to file their information returns this way. If the original file was sent magnetically, but was returned for replacement, the replacement may be transmitted electronically.

**.02** The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Customer Service toll-free number **(1-800-829-1040)** for assistance.

**.03** Files submitted to IRS/MCC electronically must be in standard ASCII code. No magnetic media or paper forms are to be submitted with the same information as the electronically submitted file.

**.04** The format is the same for electronically filed records as they are for 3 1/2-inch diskettes, tapes, and tape cartridges, and must be in standard ASCII code. For electronically filed documents, each transmission is considered a separate file.

### SEC. 4. ELECTRONIC FILING APPROVAL PROCEDURE

**.01** Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned prior to submitting their files electronically. (Filers who currently have a TCC for magnetic media filing do not have to request a second TCC for electronic filing.) Refer to Part

A, Sec. 5, for information on how to obtain a TCC.

**.02** Once a TCC is obtained, electronic filers assign their own passwords and do not need prior or special approval.

**.03** For all passwords, it is the user's responsibility to remember the password and not allow the password to be compromised. Passwords are user assigned at first logon and are up to 8 alpha/numerics, which are case sensitive. A filer who forgets their password, can call **304-263-8700** for assistance.

**Note: Passwords are case sensitive.**

## SEC. 5. ELECTRONIC SUBMISSIONS

**.01** Electronically filed information may be submitted to IRS/MCC 24 hours a day, 7 days a week. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern time by calling **304-263-8700**.

**.02** *The FIRE System will be down yearly from December 29 through January 7.* This will allow time for IRS/MCC to update its system to reflect current year changes.

**.03** Data compression is encouraged when submitting information returns electronically. *WinZip and PKZip are acceptable compression packages. UNIX COMPRESS may be acceptable; however, a test file is recommended to verify compatibility. IRS/MCC cannot accept self-extracting zip files or compressed files containing multiple files.*

The time required to transmit information returns electronically will vary depending on the modem speed and the type of data compression used, if any. **The time required to transmit a file can be reduced by as much as 95 percent by using software compression and hardware compression.**

The following are actual transmission rates achieved in test uploads at MCC using compressed files. The actual transmission rates will vary depending on the modem speeds.

<b>Transmission Speed in bps</b>	<b>1000 Records</b>	<b>10,000 Records</b>	<b>100,000 Records</b>
<b>19.2K</b>	<b>34 Sec.</b>	<b>6 Min.</b>	<b>60 Min.</b>
<b>56K</b>	<b>20 Sec.</b>	<b>3 1/2 Min.</b>	<b>33 Min.</b>
<b>128K (ISDN)</b>	<b>8 Sec.</b>	<b>1 Min.</b>	<b>10 Min.</b>

**.04** Files submitted electronically will be assigned a unique filename by the *FIRE* System (the users may name files anything they choose from their end). The *filename assigned by the FIRE System* will consist of submission type [ORIG (original), or REPL (replacement)], the filer's TCC and a four digit number sequence. The sequence number will be incremented for every file sent. For example, if it is your first original file for the calendar year and your TCC is 44444, the IRS assigned filename would be ORIG.44444.0001. Record the filename. This information will be needed by MCC in order to identify the file, if assistance is required, and to complete Form 6466.

**.05** Filers are advised not to resubmit an entire file if records were omitted from the original transmission. This will result in duplicate filing. A new file should be sent consisting of the records that had not previously been submitted.

## SEC. 6. TRANSMITTAL REQUIREMENTS

**.01** The results of the electronic transmission will be available in the File Status area of the electronic system within 10 workdays; however, no further processing will occur until the signed Form 6466 is received. The Form 6466 must be postmarked by the due date of the return. No return is considered filed until a Form 6466 is received by IRS/MCC.

**.02** Form 6466, which is located in the back of this publication, can be ordered by calling the IRS toll-free forms and publications order number **1-800-TAX-FORM (1-800-829-3676)**, or it may be computer-generated. It may also be obtained from the IRS's Internet Web Site at **www.irs.gov**. If a filer chooses to computer-generate Form 6466, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

**.03** Forms 6466 should be mailed to the following address:

If by Postal Service, air or truck freight:  
IRS-Martinsburg Computing Center  
Information Reporting Program  
**Attn: Electronic Filing Coordinator**  
240 Murall Drive  
Kearneysville, WV 25430

**Please indicate on the envelope the following message:**

**CONTAINS FORM 6466 INFORMATION - NO MAGNETIC MEDIA**

## SEC. 7. ELECTRONIC FILING SPECIFICATIONS

**.01** The FIRE System is designed exclusively for the filing of Forms 1042-S, 1099, 1098, 5498, 8027, W2-G, and W-4.

**.02** A transmitter must have a TCC before a file can be transmitted. If you have a TCC for magnetic media filing, that TCC can also be used for electronic filing.

**.03** *It is the filer's responsibility to dial back to verify the acceptability of files submitted by checking the file status area of the system. These reports will be available on the electronic system in 10 workdays after the transmission is received by IRS/MCC.*

**.04** *Contact the FIRE System by dialing **304-262-2400**. This number supports analog connections from 1200bps to 56Kbps or ISDN BRI 128Kbps connections. The system can be accessed via Dial-up network/web browser (see Section 8) or communications software (see Section 9). The Dial-up network/web browser will provide an Internet-like look without going through the Internet (point-to-point). If you do not have this capability, a text interface is provided that can be accessed via communication software such as Hyperterminal, Procomm, PCAnywhere, etc.*

## **SEC. 8. DIAL-UP NETWORK/BROWSER SPECIFICATIONS (WEB INTERFACE)**

**.01** *The following are some general instructions (many of these settings may already be set by default in your software):*

*Dial-up network settings:*

**(a)** *Set dial-up server type to PPP*

**(b)** *Set network protocol to TCP/IP*

*Browser settings:*

**(a)** *Set to receive 'cookies'*

**(b)** *Enable JavaScript or Jscript*

**(c)** *Browser must be capable of file uploads (i.e., Internet Explorer 4.0, Netscape 2.0 or higher)*

**(d)** *Enter the URL address of <http://10.225.224.2> (Remember, this is a point-to-point connection, not the Internet.)*

**.02** *Due to the large number of communication products available, it is impossible to provide specific information on all software/hardware configurations. However, since most of our filers use Windows 95, 98 or NT software, the following instructions are geared toward those products:*

### **UPLOADING FILES WITH DIAL-UP NETWORKING/WEB BROWSER IN WINDOWS 95/98**

**(1)** *This is a point-to-point connection - - not the Internet.*

**(2)** *Your browser must be capable of file uploads, i.e., Internet Explorer 4.0 or Netscape Navigator 2.0 or higher.*

**(3)** *If you currently access the Internet via a LAN or a PROXY server, you will need to disable those options in your browser and enable 'Connect to the Internet using a modem'.*

*Select **Programs***

***Accessories***

***Communications** (Windows 98)*

***Dial-Up Networking***

**First time connecting with Dial-Up Network** *(If you have logged on previously, skip to Subsequent Dial-up Network Connections.)*

*The first time you dial-in, you will need to configure your Dial-Up Networking.*

*Select **'Make new connection'**.*

*Type a descriptive name for the system you are calling.*

*Select your modem.*

*Click **'Next'**.*

*Enter area code **304** and telephone number **262-2400**.*

*Click **'Next'**.*

*When you receive a message that you have successfully created a new Dial-Up Networking connection, click **'Finish'**.*

*Click **'Connect'** to dial. If you are prompted for a user name and password, complete according to local procedures; otherwise, click **'OK'**.*

*When you receive the message that you have connected to our system, click on your Web Browser (remember, you are not connecting via the Internet - - this is a point-to-point connection).*

*In the URL Address enter <http://10.225.224.2> and press **ENTER**.*

### **Subsequent Dial-Up Network connections**

*Click **'Connect'**.*

*If prompted for user name and password, complete according to local procedures; otherwise, click **'OK'**.*

*When you receive 'Connection Complete', click **'OK'**.*

*Click on your Web Browser (remember, you are not connecting via the Internet).*

*In the URL Address enter <http://10.225.224.2> and press **ENTER**.*

**First time connection to The FIRE System** (If you have logged on previously, skip to Subsequent Connections to the FIRE System.)

Click **'Create New Account'**.

Fill out the registration form and click **'Create'**.

Enter your **logon name** (most users logon with their first and last name).

Enter your **password** (the password is user assigned and is case sensitive).

Click **'Create'**.

If you receive the message 'account created', click **'OK'**.

Click **'Start the Fire Application.'**

**Subsequent connections to The FIRE System**

Click **'Log On'**.

Enter your **logon name** (most users logon with their first and last name).

Enter your **password** (the password is user assigned and is case sensitive).

At Menu Options:

Click **'Information Returns'**

Enter your **TCC**:

Enter your **EIN**:

Click **'Submit'**.

The system will then display the company name, address, city, state, ZIP code, and phone number.

This information will be used to contact or send any correspondence regarding this transmission.

Update as appropriate and/or click **'Accept'**.

Click one of the following:

**Original File**

**Replacement File** (if you select this option, select one of the following):

**FIRE Replacement** (file was originally transmitted on this system) Click file to be replaced

**Magnetic Media Replacement File**

Enter the alpha character from Form 9267, Media Tracking Slip, that was returned with your magnetic media shipment.

Click **'Submit'**.

Enter the **drive/path/filename** of the file you want to upload or click **'Browse'** to locate the file.

Click **'Upload'**.

When the upload is complete, the screen will display the total bytes received and the file name to be recorded on your Form 6466, Box 7b.

If you have more files to upload for that TCC:

Click **'File Another'**; otherwise,

Click **'Back to Main Menu'**.

**It is your responsibility to check the acceptability of your file; therefore, be sure to dial back into the system in 10 business days.**

At the Main Menu:

Click **'File Stats'**.

Enter your **TCC**:

Enter your **EIN**:

Click **'Search'**.

If **'Results'** indicate:

**'File Good'** and you agree with the 'Count of Payees' and have mailed your Form 6466, you are finished with this file. (Form 6466 is not needed on a replacement file unless the number of payees has changed from the original/correction file.)



**'File Bad'** - Correct the errors and resubmit the file as a 'replacement'.

**'Not Yet Processed'** - File has been received, but we do not have results available yet. Please check back in a few days.

Click on the desired file for a detailed report of your transmission.

When finished viewing your files, click on **'Main Menu'**.

Click **'Log Off'**.

Close your Web Browser.

### **IMPORTANT**

Go back into your Dial-Up Network and click **'hang-up'**; otherwise, you may stay connected and incur unnecessary phone charges.

## **SEC. 9. COMMUNICATION SOFTWARE SPECIFICATIONS (TEXT INTERFACE)**

**.01** Communications software settings must be:

- No parity
- Eight data bits
- One stop bit

**.02** Terminal Emulation must be **VT100**.

**.03** Due to the large number of communication products available, it is impossible to provide specific information on all software/hardware configurations. However, since most of our filers use Windows 95, 98 or NT software, the following instructions are geared toward those products (Procomm, PCAnywhere and many other communications packages are also acceptable and the product does not necessarily need to be Windows based.):

### **UPLOADING FILES USING HYPERTERMINAL IN WINDOWS 95, 98 OR NT**

Select **Programs**

**Accessories**

**Communications** (Windows 98)

**Hyperterminal**

The first time you log on, select **Hyperterminal**, **Hyperterm** or **Hyperterm.exe**, whichever is available on your system. Thereafter, you can just select the icon that you have saved.

A box will appear titled **'Connection Description'**.

**Enter a name and choose an icon** for the connection:

Country Code: **United States of America**

Area Code: **304**

Phone Number: **262-2400**

**Connect Using: (default)**

(If you need to modify the phone number, select **File**, then **Properties** to enter defaults for the area code, phone numbers, and/or special access codes.)

Click on **Dial**.

A **'Connect'** box will appear to show the status.

Once you have connected to The FIRE System, if you do not get a menu within a few seconds, press the **ENTER** key one time.

### **First Time Logon**

When you have connected to the system, enter **'new'** to create your logon name and password.

Complete the registration information and enter **'y'** to create account.

### **Logon Name and Password**

**Logon Name:** Enter a logon name. Most users enter their first and last name as the logon name.

**Password:** Enter a password of your choosing (1-8 alpha/numerics - case sensitive).

After entering the password, you will go to the Main Menu.

### **Transferring Your Electronic File**

Enter **'A'** for Electronic Filing.

After reading Information Notice, press **ENTER**.

Enter **'A'** for Forms 1098, 1099, 5498, W-2G, 1042-S, 8027 and Questionable Forms W-4.

Press the Tab key to advance to TCC box; otherwise, enter **'E'** to exit.

Enter your **TCC**:

Enter your **EIN**:

The system will then display the company name, address, city, state, ZIP code, and phone number. This information will be used to contact or send correspondence (if necessary) regarding this transmission. If you need to update, enter '**n**' to change information; otherwise, enter '**y**' to accept.

Select one of the following:

**'A'** for an Original file

**'B'** for a Replacement file

If you selected '**B**' for a replacement file, select one of the following:

**'A'** Replacement Files For This System

This option is to replace an original/correction file that was submitted electronically on this system but was bad and needs to be replaced. Select the file needing replaced.

**'B'** Magnetic media replacement files

Enter the alpha character from Form 9267, Media Tracking Slip, that was returned with your magnetic media shipment.

Choose one of the following protocols (Hyperterminal is normally set to Zmodem by default):

**X** - Xmodem

**Y** - Ymodem

**Z** - Zmodem (Zmodem will normally give you the fastest transfer rate.)

At this point, you must start the upload from your PC.

To send a file:

Go to the hyperterminal menu bar.

Click on **Transfer**.

Click on **Send file**.

A box will appear titled 'Send File'.

Enter the drive/path/filename or click on **Browse** to locate your file.

Click on **Send**.

When the upload is complete, the screen will display the total bytes received and the file name to be recorded on your Form 6466, Box 7b.

Press **ENTER** to continue.

If you have more files to send for the same TCC/EIN, enter '**y**'; otherwise, enter '**n**'.

**It is your responsibility to check the acceptability of your file; therefore, be sure to dial back into the system in 10 business days.**

At the Main Menu:

Enter '**B**' for file status.

Press the Tab key to advance to TCC box; otherwise, enter '**E**' to exit.

Enter your **TCC**:

Enter your **EIN**:

Choose the appropriate option.

Tab to the file you want to look at and press **ENTER**.

If '**Results**' indicate:

**'File Good'** and you agree with the 'Count of Payees' and have mailed your Form 6466, you are finished with this file. (Form 6466 is not needed on a replacement file unless the number of payees changes from the original/correction file.)

**'File Bad'** - Correct the errors and resubmit the file as a replacement.

**'Not Yet Processed'** - File has been received, but we do not have results available yet. Please check back in a few days.

When you are finished, enter '**E**' from the Main Menu to logoff.

Enter '**2**' to hang-up.

## SEC. 10. MODEM CONFIGURATION

### .01 Hardware features

- (a) Enable hardware flow control
- (b) Enable modem error control
- (c) Enable modem compression

## SEC. 11. COMMON PROBLEMS ASSOCIATED WITH ELECTRONIC FILING

The following are the major non-format errors associated with electronic filing:

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### 1. No Form 6466, Transmittal of Forms W-4 Reported Magnetically/Electronically.

Even though you have sent your information returns electronically, you still need to mail a signed Form 6466 by the due date of the return. See Part C, Section 6.03, for the mailing address.

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### 2. Transmitter does not dial back to the electronic system to determine file acceptability.

The results of your file transfer are posted to the FIRE System within ten business days. It is your responsibility to verify file acceptability and, if the file contains errors, you will be mailed a listing of the errors. Date received and number of payee records are also displayed.

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### 3. *Incorrect file is not replaced timely.*

*If your file is bad, correct the file and timely resubmit as a replacement.*

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### 4. Transmitter compresses several files into one.

Only compress one file at a time. For example, if you have 10 uncompressed files to send, compress each file separately and send 10 separate compressed files.

---

### 5. Transmitter sends a file and File Status indicates that the file is good, but the transmitter wants to send a replacement file to replace the original file.

Once a file has been transmitted, you cannot send a replacement file unless File Status indicates the file is bad (10 business days after file was transmitted). If you do not want us to process the file, you must first contact us at 304-263-8700 to see if this is a possibility. However, this will count as a replacement.

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### 6. File is formatted as EBCDIC.

All files submitted electronically must be in standard ASCII code.

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## Part D. Miscellaneous Information

### Sec. 1. Addresses for Martinsburg Computing Center

*To submit an application to file, Form 6466, correspondence, and magnetic media files, use the following:*

*Mailing by U. S. Postal Service, truck, or air freight:*



*IRS—Martinsburg Computing Center  
Information Reporting Program  
240 Murall Drive  
Kearneysville, WV 25430*

### Sec. 2. Telephone Numbers for Contacting IRS/MCC

*Information Reporting Program Call Site: 304-263-8700*

*Telecommunication Device for the Deaf (TDD): 304-267-3367*

*Between 8:30 a.m. and 4:30 p.m. Eastern Time  
Monday through Friday*

*Electronic Filing via FIRE - 1-304-262-2400*

*Information Returns FAX Machine: 304-264-5602*



*HOURS OF OPERATION – FIRE SYSTEM & FAX  
24 HOURS A DAY  
7 DAYS A WEEK*

*This is the end of Publication 1245 for Tax Year 2000.*



## Part IV. Items of General Interest

### Notice of Proposed Rulemaking; Notice of Proposed Rulemaking by Cross Reference to Temporary Regulations; and Notice of Public Hearing

#### Electing Small Business Trust

#### REG-251701-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of proposed rulemaking by cross reference to temporary regulations; and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the qualification and treatment of electing small business trusts (ESBTs). The proposed regulations interpret the rules added to the Internal Revenue Code (Code) by section 1302 of the Small Business Job Protection Act of 1996 and section 1601 of the Taxpayer Relief Act of 1997. In addition, the text of the temporary regulations published in T.D. 8915, page 359, also serves as the text of these proposed regulations with respect to an ESBT or a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) not being treated as a deferral entity for purposes of §1.444-2T. The proposed regulations affect S corporations and certain trusts that own S corporation stock. This document also provides notice of a public hearing on these regulations.

DATES: Written or electronic comments must be received by April 4, 2001. Requests to speak (with outlines of oral comments to be discussed) at a public hearing scheduled for April 25, 2001, at 10 a.m. must be received by April 4, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-251701-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-251701-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers

may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in the Internal Revenue Building Auditorium, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bradford Poston or James A. Quinn, (202) 622-3060; concerning submissions and the hearing, Sonya M. Cruz, (202) 622-7190; (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Paperwork Reduction Act

The collections of information in this notice of proposed rulemaking have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control numbers 1545-1523 and 1545-1591.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

##### Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to S corporations and electing small business trusts (ESBTs). Section 1302 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755) (August 20, 1996) (the 1996 Act), amended sections 641 and 1361 of the Code to permit an ESBT to be an S corporation shareholder. Further amendments were made to section 1361(e) by the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 1601(c)(1)) (August 5, 1997). Prior section 641(d) was redesignated as

section 641(c) by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 6007(f)(2)) (July 22, 1998).

#### Explanation of Provisions

##### Overview

Prior to the 1996 Act, the only trusts that were permitted S corporation shareholders were wholly-owned grantor trusts, voting trusts, certain grantor trusts after the grantor's death, and qualified subchapter S trusts (QSSTs). These trusts are not taxed at the trust level, and the deemed owner or owners are taxed directly on the tax items of the trusts, except for certain testamentary trusts described in §1.1361-1(j)(7)(ii). QSSTs are required to have a single income beneficiary, and all of the income must be currently distributed to such beneficiary. The 1996 Act created ESBTs to allow more flexibility in the types of trusts that are permitted S corporation shareholders and, in particular, to facilitate family financial planning. H. Rep. No. 586, 104<sup>th</sup> Cong., 2d Sess. 82 (1996), S. Rep. No. 281, 104<sup>th</sup> Cong., 2d Sess. 46 (1996). Unlike a QSST, an ESBT may have multiple beneficiaries and may also accumulate trust income.

Section 1361(e)(1) defines the term *electing small business trust* as any trust if: (1) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2) through (5); (2) no interest in the trust was acquired by purchase; and (3) an election has been made with respect to the trust.

Section 1361(c)(2)(B)(v) provides that, for purposes of section 1361(b)(1) (the S corporation shareholder limitations), each potential current beneficiary of an ESBT will be treated as a shareholder. During any period that there is no potential current beneficiary of an ESBT, the trust shall be treated as the shareholder.

##### ESBT Beneficiaries

Notice 97-49 (1997-2 C.B. 304) clarifies the definitions of beneficiary (for purposes of section 1361(e)(1)(A)(i)) and potential current beneficiary (for purposes of section 1361(e)(2)) and also clarifies

the treatment of ESBT distributions. The proposed regulations, when finalized, will modify and replace the rules of Notice 97-49.

### *Beneficiary*

The proposed regulations provide guidance as to who is an ESBT beneficiary. Generally, a beneficiary includes any person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest. If an ESBT makes distributions to another trust (the distributee trust), the distributee trust is not treated as a beneficiary of the ESBT. However, the beneficiaries of the distributee trust will be counted as beneficiaries of the ESBT. Persons whose future beneficial interest is so remote as to be negligible are not beneficiaries. Generally, when the probability that a person will receive any distribution from the trust is less than 5 percent, at a particular time, that person's interest would be so remote as to be negligible. Finally, the term *beneficiary* does not include a person in whose favor a power of appointment may be exercised until the power is actually exercised.

### *Interests Acquired by Purchase*

The proposed regulations provide guidance regarding the prohibition on acquiring an interest in an ESBT by purchase. The proposed regulations provide that the prohibition applies if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012. Thus, a part-gift, part-sale of a beneficial interest will terminate the trust's status as an ESBT. Beneficiaries may not purchase interests in the trust, but the ESBT itself is allowed to purchase S corporation stock.

### *Grantor Trusts*

The proposed regulations provide that a trust, all or a portion of which is treated as owned by an individual under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (Code) (a grantor trust), may elect to be an ESBT. The Treasury Department and the IRS believe that Congress did not intend to preclude this type of trust, which is a common family estate planning tool, from electing ESBT status. The proposed regulations

provide rules for the treatment of grantor trusts electing ESBT status.

### *Potential Current Beneficiaries*

The proposed regulations provide that the term *potential current beneficiary* means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. In general, a person who may receive a distribution from the ESBT under a currently exercisable power of appointment is a potential current beneficiary. In addition, in the case of an ESBT that is a grantor trust, the proposed regulations provide that the deemed owner of the grantor trust is also to be treated as a potential current beneficiary.

Under the definitions set forth in the proposed regulations, a potential current beneficiary is not necessarily a beneficiary of the trust and vice versa. For example, a person in whose favor property could currently be appointed, but to whom no such appointment has been made, is a potential current beneficiary, but not a beneficiary. Conversely, a person who is a non-contingent remainder beneficiary of a non-grantor trust is a beneficiary, but not a potential current beneficiary.

The proposed regulations provide special rules if current distributions can be made to a distributee trust. If the distributee trust does not qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), then the trust is considered the potential current beneficiary and thus a shareholder. In that case, the corporation's S election terminates because the corporation has an ineligible shareholder. For this purpose, a trust is deemed to qualify to be a shareholder of an S corporation under section 1361(c)(2)(A) if it would be eligible to make a QSST or ESBT election if it owned S corporation stock.

If the distributee trust does qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), in general, the potential current beneficiaries of the distributing ESBT will include the potential current beneficiaries of the distributee trust. However, if the distributee trust is a former grantor trust prior to the owner's death (that is, a trust described in section 1361(c)(2)(A)(ii)), or is a trust receiving a

distribution of S stock from a decedent's estate (that is, a trust described in section 1361(c)(2)(A)(iii)), the estate of the decedent is treated as the only potential current beneficiary of the trust. In no case will the same person be counted twice when determining the number of S corporation shareholders.

### *ESBT Election*

Notice 97-12 (1997-1 C.B. 385) provides the procedures for making the ESBT election. Under that notice, the ESBT election is required to contain certain information and representations, and is required to be filed with the service center where the S corporation files its income tax returns. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, the trustee of an ESBT makes a single ESBT election by filing a statement with the service center where the ESBT files its Form 1041, *U.S. Income Tax Return for Estates and Trusts*. This procedure will be more convenient for taxpayers than the procedures of Notice 97-12 if the ESBT holds stock in more than one S corporation. No trust documents are required to be attached to the election statement.

The proposed regulations provide that if a trust satisfies the ESBT requirements and makes an ESBT election, the trust will be treated as an ESBT for federal income tax purposes as of the effective date of the ESBT election. These effective dates generally follow the rules of §1.1361-1(j)(6)(iii) for qualified subchapter S trust (QSST) elections. Protective ESBT elections, which are intended to become effective only if the trust fails to satisfy the requirements for a trust described in section 1361(c)(2)(A)(i) through (iv), are prohibited. Unlike a protective QSST election, a protective ESBT election could result in a change in the incidence of taxation from the owner of the trust to the trust itself. If a trust fails to qualify as an eligible S corporation shareholder under section 1361(c)(2), and consequently the S corporation election is ineffective or terminated, relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation termination.

Rev. Proc. 98-23 (1998-1 C.B. 662) provides procedures for the conversion of a QSST to an ESBT and an ESBT to a QSST. The proposed regulations, when finalized, will modify and replace the procedures of Rev. Proc. 98-23 and provide rules with respect to these conversions.

The conversion procedure provided in the proposed regulations differs from that provided in Rev. Proc. 98-23, in that the election must be filed with the service center where the trust files its income tax return, as well as with the service center where the S corporation files its income tax return. The election must be filed in both service centers if the service center for the trust is different from the service center for the S corporation because QSST elections are filed with the service center where the S corporation files its income tax return and ESBT elections will be filed where the trust files its income tax return under the new procedures set forth in these proposed regulations, when finalized. The IRS and the Treasury Department specifically request comments on whether the rules for filing QSST elections similarly should be changed to permit the filing of a QSST election with the service center where the trust files its return rather than with the service center for the S corporation(s).

#### *Consent to the S Corporation Election*

Notice 97-12 provides that, for purposes of the ESBT's consent to the S corporation election under section 1362(a), only the trustee needs to consent to the S corporation election because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, if the ESBT is also a grantor trust, the deemed owner must also consent to the S corporation election because such owner will be taxed on all or a portion of the S corporation's income. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

#### *ESBT Taxation*

The proposed regulations provide that, for federal income tax purposes, an ESBT

consists of an S portion, a non-S portion, and in some instances a grantor portion. The items of income, deduction, and credit attributable to any portion of the ESBT treated as owned by a person under the grantor trust rules of subpart E, including S corporation stock and other property (the grantor portion), are taken into account on that individual's tax return pursuant to the normal rules applicable to grantor trusts. Other items of income, deduction, and credit are, pursuant to these proposed regulations, attributed to either the S portion, which includes the S corporation stock, or the non-S portion, which includes all other assets of the trust. The S portion is subject to tax under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible by the S portion, and the deduction is limited to the amount of the gross income of the S portion. If a payment is made to a charitable organization by the ESBT pursuant to the terms of its governing instrument, such payment is deductible, subject to the provisions of section 642(c)(1), to the extent it is paid from the gross income of the non-S portion of the trust. Thus, if the ESBT contributes S corporation stock to a charitable organization, no deduction is allowed under section 642(c)(1) because the contribution is not paid out of the gross income of the non-S portion.

The proposed regulations provide guidance regarding the treatment of proceeds received by an ESBT from the sale of S corporation stock when income from the sale is reported on the installment method under section 453. The income recognized with respect to the installment proceeds is taken into account by the S portion. The interest on the installment obligation is taken into account by the non-S portion.

The proposed regulations provide that if a trust holds S corporation stock and is

already an eligible S corporation shareholder and the trust makes an ESBT election during the trust's taxable year, the electing trust will be treated as a separate taxpayer for purposes of allocating S corporation items under section 1377(a)(1). However, the ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of §1.1377-1(b), unless the prior trust is one described in section 1361(c)(2)(A)(ii) or (iii). Therefore, the S corporation is generally not permitted to make the election to terminate the taxable year under section 1377(a)(2). The trust will be treated as a single taxpayer for purposes of determining the taxation of distributions from the trust. Thus, distributions made after the effective date of the ESBT election may still carry out distributable net income of the trust earned during the taxable year before the effective date of the ESBT election.

The proposed regulations provide that for purposes of determining whether the exception to estimated taxes under section 6654(d)(1)(B) applies, the trust will not be considered a different taxpayer as a result of the ESBT election. Therefore, if the ESBT makes estimated tax payments equal to 100 percent of the prior year's tax liability, no penalties will apply.

The proposed regulations provide that interest expenses paid on loans used to purchase the S corporation stock must be allocated to the S portion of the ESBT but are not deductible by the S portion because they are not administrative expenses.

#### *ESBT Terminations*

The proposed regulations provide that generally a trustee must seek the consent of the Commissioner to revoke its ESBT election by obtaining a private letter ruling. However, the Commissioner's consent is granted for revocations that occur on the conversion of an ESBT to a QSST under the procedures set forth in the proposed regulations.

The proposed regulations provide that if an ESBT fails to meet the definitional requirements of an ESBT under section 1361(e), the trust's ESBT status terminates immediately upon such failure to qualify. However, if an ESBT acquires an ineligible potential current beneficia-



ry, the ESBT has 60 days in which to dispose of all of its S corporation stock to prevent termination of the S corporation election. If the S corporation stock is not disposed of within the 60-day period, then the S corporation election will terminate as of the first day that the ineligible person became a potential current beneficiary.

Finally, the proposed regulations provide that an ESBT election generally is terminated if the ESBT fails to hold any S corporation stock. However, a trust will continue to be treated as an ESBT if it is reporting income from the sale of S corporation stock under the installment method of section 453.

#### *Section 444 Elections*

The text of the temporary regulations published in T.D. 8915 serves as the text of these proposed regulations with respect to an ESBT and a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a). These temporary regulations provide that an ESBT and a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) are not deferral entities for purposes of §1.444-2T.

#### **Proposed Effective Date**

The regulations regarding ESBTs under §1.641-1(d) through (k), §1.1361-1(h)-(1)(vi), (h)(3)(i)(F), (j)(12), and (m), §1.1362-6(b)(2)(iv), §1.1377-1(a)(2)(iii) and (c) *Example 3* are proposed to apply on and after the date the final regulations are published in the **Federal Register**. The IRS and the Treasury Department have become aware of potentially abusive transactions involving ESBTs that assume the applicability of the rules of section 641(c) to the taxation of the grantor portion of such trusts. See Notice 2000-61, 2000-49 I.R.B. 1. Thus, the regulations regarding taxation of ESBTs under §1.641(c)-1(a), (b) and (c) are proposed to be applicable for taxable years of ESBTs that end on and after the proposed regulations are filed in the **Federal Register**.

#### **Effect on Other Documents**

The following documents are proposed to be superseded as of the date the final

regulations are published in the **Federal Register**:

Notice 97-12 (1997-1 C.B. 385).

Notice 97-49 (1997-2 C.B. 304).

Rev. Proc. 98-23 (1998-1 C.B. 662).

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in the regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the estimated average burden per trust in complying with the collections of information in §1.1361-1(m) is 1 hour. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 25, 2001, at 10:00 a.m. in the Internal Revenue Building Auditorium, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 4, 2001, and submit an outline of the topics to be discussed and

the time to be devoted to each topic (signed original and eight (8) copies) by April 4, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Drafting Information**

The principal authors of these regulations are Bradford Poston and James A. Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART I—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Section 1.444-4 is also issued under 26 U.S.C. 444(g).

Par. 2. Section 1.444-4 is added to read as follows:

*§1.444-4 Tiered structure.*

[The text of this proposed section is the same as the text of §1.444-4T published T.D. 8915].

Par. 3. Sections 1.641(c)-0 and 1.641(c)-1 are added to read as follows:

*§ 1.641(c)-0 Table of contents.*

This section lists the following captions contained in §1.641(c)-1:

*§1.641(c)-1 Electing small business trust.*

- (a) In general.
- (b) Definitions.
- (1) Grantor portion.
- (2) S portion.
- (3) Non-S portion.
- (c) Taxation of grantor portion.



- (d) Taxation of S portion.
  - (1) In general.
  - (2) Section 1366 amounts.
  - (3) Gains and losses on disposition of S stock.
  - (4) State and local income taxes and administrative expenses.
  - (e) Tax rates and exemption of S portion.
    - (1) Income tax rate.
    - (2) Alternative minimum tax exemption.
  - (f) Taxation of non-S portion.
    - (1) In general.
    - (2) Dividend income under section 1368(c)(2).
    - (3) Interest on installment obligations.
    - (4) Charitable deduction.
    - (g) Allocation of state and local income taxes and administration expenses.
    - (h) Treatment of distributions from the trust.
    - (i) Termination or revocation of ESBT election.
    - (j) Effective date.
    - (k) Examples.

*§ 1.641(c)–1 Electing small business trust.*

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of determining income tax. The portion of an ESBT that consists of stock in one or more S corporations (the S portion) is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. In addition, the non-S portion may consist of more than one share pursuant to section 663(c). See § 1.1361–1(m) for the treatment of an ESBT as a single trust for administrative purposes.

(b) *Definitions*—(1) *Grantor portion.* The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion.* The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another

person under subpart E.

(3) *Non-S portion.* The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion.* The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion*—(1) *In general.* The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts*—(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Normal rules applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361–1(m)(3)(iv) for allocation of those items in the taxable year in which the ESBT election is made if, before the effective date of the election, the trust was a shareholder of the S corporation.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible in computing the taxable income of the S portion. Such a deduction cannot exceed the amount of gross income of the S portion.

(iii) *Multiple S corporations.* If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock*—(i) *In general.* The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (f)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361–1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis.* Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses*—(i) *In general.* State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (g) are taken into account by the S portion.

(ii) *Special rule for certain interest.* Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion*—(1) *Income tax rate.* Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption.* The exemption amount of the S portion under section 55(d) is zero.

(f) *Taxation of non-S portion*—(1) *In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) *Dividend income under section 1368(c)(2).* Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction.* For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(g) *Allocation of state and local income taxes and administration expenses.* Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner

that is reasonable in light of all the circumstances, including the terms of the governing instrument, local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(h) *Treatment of distributions from the trust.* Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are included in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(i) *Termination or revocation of ESBT election.* If the ESBT election of the trust terminates pursuant to §1.1361-1(m)(5) or the ESBT election is revoked pursuant to §1.1361-1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating

loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(j) *Effective date.* This section generally is applicable on and after the date the final regulations are published in the **Federal Register**. However, paragraphs (a), (b) and (c) of this section are applicable for taxable years of ESBTs that end on and after December 28, 2000.

(k) *Examples.* The following examples illustrate the rules of this section:

*Example 1. Comprehensive example.* (i) Trust has a valid ESBT election in effect. Under section 678, B is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E, part I, subchapter J. Trust owns stock in X, an S corporation, and in Y, a C corporation. During 2000, Trust receives a distribution from X of \$5,100, of which \$5,000 is applied against Trust's adjusted basis in the X stock in accordance with section 1368(c)(1) and \$100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to X under section 1366Y .....	\$5,000
Dividend income from Y .....	\$900
Dividend from X representing C corporation earnings and profits .....	\$100
Total trust income .....	\$6,000
Charitable contributions attributable to X under section 1366 .....	\$300
Trustee fees .....	\$200
State and local income taxes .....	\$100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

<i>B</i> must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:	
Ordinary income from X .....	\$500
Dividend income from Y .....	\$90
Dividend income from X .....	\$10
Total grantor portion income .....	\$600
The total income of the S portion is \$4,500, determined as follows:	
Ordinary income from X .....	\$5,000
Less: Grantor portion .....	(\$500)
Total S portion income .....	\$4,500
The total income of the non-S portion is \$900 determined as follows:	
Dividend income from Y (less grantor portion) .....	\$810
Dividend income from X (less grantor portion) .....	\$90
Total non-S portion income .....	\$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the \$6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) <i>B</i> must take into account the following deductions attributable to the grantor portion of the trust:	
Charitable contributions from X .....	\$30

Trustee fees .....	\$20
State and local income taxes .....	\$10
(vi) The taxable income of the S portion is \$4,005, determined as follows:	
Ordinary income from X .....	\$4,500
Less: Charitable contributions from X (less grantor portion) .....	(\$270)
75% of trustee fees .....	(\$150)
75% of state and local income taxes .....	(\$75)
Taxable income of S portion .....	\$4,005
(vii) The taxable income of the non-S portion is \$755, determined as follows:	
Dividend income from Y .....	\$810
Dividend income from X .....	\$90
Total non-S portion income .....	\$900
Less: 15 % of trustee fees .....	(\$30)
15% state and local income taxes .....	(\$15)
Personal exemption .....	(\$100)
Taxable income of non-S portion .....	\$755

*Example 2. Sale of S stock.* Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E, part I, subchapter J. In 2001, Trust sells all of its stock in X and recognizes a capital gain of \$5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

*Example 3. (i) Sale of S stock for an installment note.* Assume the same facts as in *Example 2*, except that Trust sells its stock in X for a \$400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) *Loss on installment sale.* Assume Trust's basis in its X stock was \$500,000. Therefore, Trust sustains a capital loss of \$100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) *Gain on installment sale.* Assume Trust's basis in its X stock was \$300,000 and that the \$100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the \$100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

*Example 4. Charitable lead annuity trust.* Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in X, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays \$10,000 to a section 170(c)(2) charitable organization. The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion, no charitable deduction is available to the S portion.

*Example 5. ESBT distributions.* (i) As of January 1, 2000, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2001, and Trust elects to be an ESBT effective January 1, 2001. For

2001, Trust's share of X's section 1366 items is \$5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes. On February 1, 2001, X makes an \$8,000 distribution to Trust, of which \$3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the X stock under section 1368(b). The trustee of Trust makes a distribution of \$4,000 to Beneficiary during 2001.

(ii) For 2001, Trust has \$5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has \$3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of \$3,000, which represents the amount distributed to the beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). The beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

Par. 4. Section 1.1361-0 is amended by adding entries for § 1.1361-1(j)(12) and (m) to read as follows:

#### § 1.1361-0 Table of contents.

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#### § 1.1361-1 S corporation defined.

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#### (j) \*\*\*\*\*

#### (12) Converting a QSST to an ESBT.

\*\*\*\*\*

#### (m) Electing small business trust (ESBT).

#### (1) Definition.

#### (2) ESBT election.

#### (3) Effect of ESBT election.

#### (4) Potential current beneficiaries.

#### (5) ESBT terminations.

#### (6) Revocation of ESBT election.

#### (7) Converting an ESBT to a QSST.

#### (8) Effective date.

#### (9) Examples.

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Par. 5. Section 1.1361-1 is amended by:

1. Adding paragraphs (h)(1)(vi), (h)(3)(i)(F), and (j)(12).

2. Adding a sentence to the end of paragraph (k)(2)(i).

3. Adding paragraph (m).

The additions read as follows:

#### § 1.1361-1 S corporation defined.

\*\*\*\*\*

#### (h) \*\*\*\*\* (1) \*\*\*\*\*

(vi) *Electing small business trusts.* An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3). \*\*\*\*\*

#### (3) \*\*\*\*\* (i) \*\*\*\*\*

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

\*\*\*\*\*

#### (j) \*\*\*\*\*

#### (12) Converting a QSST to an ESBT.

For a trust that wishes to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the

requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return and also with the service center where the trust files its income tax return. This ESBT election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-1(j)" and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(k) \* \* \*

(2) \* \* \* (i) \* \* \* Paragraphs (h)(1)(vi), (h)(3)(i)(F), and (j)(12) of this section are applicable on and after the date the final regulations are published in the **Federal Register**.

\* \* \* \* \*

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule*. An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2) through (5); no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general*. For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest within the meaning of paragraph (m)(1)(ii)(D) of this section.

(B) *Distributee trusts*. Any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. However, if the distributee trust is an organization described in section 170(c)(2) or (3), the distributee trust itself is the beneficiary of the ESBT. A distributee trust is a trust that is receiving or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment*. A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Remote beneficiaries*. A person whose interest in the trust is so remote as to be negligible is not a beneficiary of an ESBT. With respect to any portion of the trust, a person's interest in either the corpus or the income therefrom is, at any time, so remote as to be negligible when the probability that such person will ever receive a distribution from the trust is less than 5 percent, taking into consideration the interests of other entities and other individuals living at that time.

(E) *Nonresident aliens*. A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT.

(iii) *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. If any portion of a beneficiary's basis in the beneficiary's interest in the trust is determined under section 1012, such interest has been acquired by purchase. The trust itself may acquire S corporation stock by purchase.

(iv) *Ineligible trusts*. An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with

respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general*. The trustee of the trust must make the ESBT election by signing and filing, with the service center where the trust files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. Only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT.

(ii) *Election statement*. The election statement must include—

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently owns stock;

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that—

(I) The trust meets the definitional requirements of section 1361(e)(1); and

(2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).

(iii) *Due date for ESBT election*. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election. If the trust and the corporation file their tax returns with the same service center, the trustee may attach the ESBT election to the Form 2553, "Election by a Small Business Corporation," in the case of a newly electing S corporation.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii)*. A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii)



may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election.* A trust cannot make a protective ESBT election that would be effective in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make a protective ESBT election and fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination.

(3) *Effect of ESBT election*—(i) *General rule.* If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) *Employer Identification Number.* An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, and the trust held S corporation stock and was an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv) prior to the effective date of the ESBT election, the S corporation items are allocated between the two eligible trusts under section 1377(a). For purposes of section 1377(a), the first day the ESBT is a shareholder is the effective date of the ESBT election, and the last day the other trust is a shareholder is the day

before the effective date of the ESBT election. See § 1.1377-1(a)(2)(iii).

(v) *Estimated taxes.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries*—(i) *In general.* For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this section (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust.

(ii) *Grantor trusts.* If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock.* Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of its S corporation stock, any person who first met the definition of a potential current beneficiary during the 60-day period ending on the date of such disposition is not a potential current beneficiary with respect to that corporation.

(iv) *Distributee trusts*—(A) *In general.* This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraph (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B) (ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period for which such trust is permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would be eligible to make a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions.* A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) *Current powers of appointment.* A person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a general lifetime power of appointment over the trust, the corporation's S corporation election will terminate because the number of potential current beneficiaries will exceed the 75-shareholder limit of section 1361(b)(1)(A).

(vii) *Number of shareholders.* Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for exam-

ple, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, such husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous.* Payments made to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations—(i) Ceasing to meet ESBT requirements.* A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock.* In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders.* If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(ii) of this section. If the S corporation election ter-

minates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election.* An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST.* For a trust that wishes to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return and also with the service center where the trust files its income tax return. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)" and include all information otherwise required for a QSST election under § 1.1361-1(j)(6). A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(8) *Effective date.* This paragraph (m) is applicable on and after the date the final

regulations are published in the **Federal Register**.

(9) *Examples.* The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all non-corporate persons are citizens or residents of the United States:

*Example 1. (i) ESBT election with section 663(c) separate shares.* On January 1, 2000, M contributes S corporation stock to Trust for the benefit of M's three children A, B, and C. Pursuant to section 663(c), each of Trust's separate shares for A, B, and C will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2000, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2000. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(ii) *ESBT acquires stock of an additional S corporation.* On February 15, 2000, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(iii) *Section 663(c) shares of ESBT convert to separate QSSTs.* Effective January 1, 2001, A, B, C, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. They file a separate election for each S corporation the stock of which is held by Trust for each separate share. Each separate share will be treated as a separate QSST.

*Example 2. (i) Invalid potential current beneficiary.* Effective January 1, 2000, Trust makes a valid ESBT election. On January 1, 2001, A, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within 60 days after January 1, 2001. As of January 1, 2001, A is a potential current beneficiary of Trust, and therefore is treated as a shareholder of the S corporation. Because A is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2001. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock.* Assume the same facts as in Example 2 (i) except that within 60 days after January 1, 2001, trustee of Trust disposes of all Trust's S corporation stock. A is not considered a potential current beneficiary of Trust and therefore is not treated as an S corporation shareholder of any S corporation in which Trust previously held stock.

*Example 3. Subpart E trust.* M transfers stock in X, an S corporation, and other assets to Trust, for the benefit of B and B's siblings. M retains no powers or interest in Trust. Under section 678(a), B is treated as the owner of a portion of Trust which includes a portion of the X stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

*Example 4. Determining ESBT beneficiaries.* Trust holds stock in an S corporation and makes an ESBT election. Trust's instrument provides that

income is to be paid to A for A's life. Upon A's death the remainder interest is to be paid to a separate trust for the benefit of A's three children. If on A's death none of A's children is alive, then the remainder is to be paid to A's ten grandchildren. If on A's death none of A's children or grandchildren is alive, the remainder will be paid to State exclusively for public purposes. A, A's children, and A's grandchildren are all beneficiaries of Trust. Assuming the probability that State will ever receive any distribution from Trust is less than 5 percent, State is not considered a beneficiary for purposes of paragraph (m)(1)(ii) of this section. If the probability that State will receive a distribution from Trust ever equals or exceeds 5 percent, State would then be considered a beneficiary of the ESBT. Because State is an organization described in section 170(c)(1), rather than section 170(c)(2) through (5), State would be an ineligible beneficiary and the corporation's S corporation election would terminate.

*Example 5. Potential current beneficiaries and distributee trusts.* (i) *Distributee trust holding S corporation stock.* Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to distribute to A directly or to any trust created for the benefit of A. On January 1, 2000, M creates Trust-2 for the benefit of A. Also on January 1, 2000, the trustee of Trust-1 distributes some S corporation stock to Trust-2. The current income beneficiary of Trust-2 makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the 75-shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

(ii) *Distributee trust not holding S corporation stock.* Assume the same facts as in paragraph (i) of this *Example 5*, except that no S corporation stock is distributed to Trust-2. Because Trust-2 would be eligible to make a QSST election or an ESBT election if it owned S corporation stock, under paragraph (m)(4)(iv)(D) of this section it is deemed to be a trust described in section 1361(c)(2)(A). Under paragraph (m)(4)(iv)(C) of this section, the potential current beneficiaries of Trust-2 are considered the potential current beneficiaries of Trust-1. Because A, the potential current beneficiary of Trust-2, is already a potential current beneficiary of Trust-1, A is not counted twice for purposes of the 75-shareholder limit of the S corporation.

*Example 6. Potential current beneficiaries and distributee trust.* (i) *Distributee trust that would itself qualify as an ESBT.* Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of the governing instrument of Trust-1, the trustee has discretion to make distributions to A, B and Trust-2, a trust for the benefit of A and B's children, C, D and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D

and E are potential current beneficiaries of Trust-1 and are counted as shareholders for the purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT.* Assume the same facts as in *Example 6* (i) except that D is a non-resident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust.* Assume the same facts as in *Example 6* (i) except that Trust-2 is a trust treated as owned by A under section 676 because A had the power to revoke Trust-2 at any time prior to A's death. On January 1, 2001, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate.

*Example 7. Potential current beneficiaries and powers of appointment.* M creates Trust for the benefit of A. A also has a current power to appoint income or principal to anyone except A, A's creditors, A's estate, and A's estate's creditors. The potential current beneficiaries of Trust will be A and all other persons except for A's creditors, A's estate, and A's estate's creditors. This number will exceed the 75-shareholder limit of section 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

Par. 6. Section 1.1362-6 is amended by revising paragraph (b)(2)(iv) to read as follows:

*§ 1.1362-6 Election and consents.*

- \* \* \* \* \*
- (b) \* \* \*
- (2) \* \* \*

(iv) *Trusts.* In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part

I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

\* \* \* \* \*

Par. 7. Section 1.1362-7 is amended by adding a sentence to the end of paragraph (a) to read as follows:

*§ 1.1362-7 Effective date.*

(a) \* \* \* Section 1.1362-6(b)(2)(iv) is applicable on and after the date the final regulations are published in the **Federal Register**.

\* \* \* \* \*

Par. 8. Section 1.1377-1 is amended by:

1. Adding paragraph (a)(2)(iii).
  2. Adding *Example 3* to paragraph (c).
- The additions read as follows:

*§ 1.1377-1 Pro rata share.*

- (a) \* \* \*
- (2) \* \* \*

(iii) *Electing small business trust (ESBT) election.* If an ESBT election is effective on a day other than the first day of trust's taxable year, and the trust was already an eligible S corporation shareholder under a different provision of section 1361(c)(2), then section 1377 applies to allocate S corporation income between the two types of trusts. The first day the ESBT is treated as an S corporation shareholder is the effective date of the ESBT election. The ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of paragraph (b) of this section, unless the prior trust was described in section 1361(c)(2)(A)(ii) or (iii).

\* \* \* \* \*

- (c) \* \* \*

*Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT).* (i) On January 1, 2000, Trust receives 100% of the stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2000. Later, the trustee and current income beneficiary of Trust elect pursuant to § 1.1361-1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2002. In 2002, Trust's *pro rata* share of S corporation's nonseparately computed income is \$100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated



as a QSST through June 30, 2002, and Trust is treated as an ESBT beginning July 1, 2002. Pursuant to section 1377(a)(1), the *pro rata* share of S corporation income allocated to the QSST is \$49,589 (\$100,000 x 181 days/365 days), and the *pro rata* share of S corporation income allocated to the ESBT is \$50,411 (\$100,000 x 184 days/365 days).

Par. 9. Section 1.1377-3 is amended by revised to read as follows:

*§ 1.1377-3 Effective date.*

Section 1.1377-1 and 1.1377-2 apply to taxable years of an S corporation beginning after December 31, 1996, except that § 1.1377-1(a)(2)(iii) and (c) *Example 3* are applicable on and after the date the final regulations are published in the **Federal Register**.

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

(Filed by the Office of the Federal Register on December 28, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 29, 2000, 65 F.R. 82963)

## Notice of Proposed Rulemaking and Notice of Public Hearing

### Application of Section 904 to Income Subject to Separate Limitations and Computation of Deemed-Paid Credit under Section 902

#### REG-104683-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed Income Tax Regulations relating to the computation of the section 902 deemed-paid credit, the section 904(d) foreign tax credit limitation, and to an example in the section 954 regulations relating to the exclusion of certain export financing interest from foreign personal holding company income. Changes to the applicable law were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Taxpayer Relief Act of 1997. These regulations would provide guidance needed to comply with these changes and would affect individuals and corporations

reporting subpart F income and claiming foreign tax credits.

This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 2, 2001. Outlines of topics to be discussed at the public hearing scheduled for April 26, 2001, at 10 a.m. must be received by April 5, 2001.

ADDRESSES: Send submissions to: Regulations Unit CC (REG-104683-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to Regulations Unit CC (REG-104683-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the IRS Internet site at: [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in the IRS Auditorium, 7<sup>th</sup> floor, Internal Revenue Building, 1111 Constitution Ave., NW., Washington, DC. FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bethany A. Ingwalson (202) 622-3850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

Treasury and the IRS provided guidance regarding section 904(d) (enacted in 1986) in T.D. 8214 (1988-2 C.B. 220), T.D. 8412 (1992-1 C.B. 271), T.D. 8556 (1994-2 C.B. 165), T.D. 8805 (1999-1 C.B. 371), and in final regulations (T.D. 8916) published on page 360 of this Bulletin. Final regulations regarding the computation of the deemed paid credit under section 902 (also enacted in 1986) were published as T.D. 8708 (1997-1 C.B. 137). The proposed regulations provide further guidance with respect to the application of sections 902 and 904(d).

The proposed regulations also provide guidance regarding the application of section 904(j). The Taxpayer Relief Act of 1997 (Public Law 105-34, 111 Stat. 788) (TRA 1997) added section 904(j) to the

Internal Revenue Code (Code). Section 904(j) exempts individuals from the foreign tax credit limitation of section 904(a) in certain limited circumstances, and provides that no foreign taxes may be carried to or from a year for which a taxpayer has elected to apply section 904(j).

TRA 1997 also added to the Code section 904(b)(2)(C), which provides that the Secretary may issue regulations to modify the application of section 904(b)(2) and (3) to properly reflect capital gain rate differentials under sections 1(h) and 1201(a) and the computation of net capital gain. The proposed regulations provide guidance for the application of section 904(b), including the application of that section in years in which section 1(h) provides for more than one capital gains rate.

#### Explanation of Provisions

##### *I. Effect of Loss of Domestic Corporate Shareholder on Pooling of Earnings and Taxes in Computing Deemed Paid Credits: §1.902-1*

Under section 902(c)(3), the multi-year pools of post-1986 undistributed earnings and post-1986 foreign income taxes of a foreign corporation are determined by taking into account only periods beginning on and after the first day of the foreign corporation's first taxable year in which a domestic corporation (a "qualifying shareholder") owns 10 percent or more of its voting stock or, in the case of a lower-tier foreign corporation in a "qualified group" described in section 902(b)(2), owns indirectly at least 5 percent of its voting stock.

Under section 902(c)(6)(B), dividends are treated as paid first out of the post-1986 pooled earnings. Pre-1987 accumulated profits (defined in section 902(c)(6)(A) and §1.902-1(a)(10) to include both earnings accumulated in pre-1987 years and earnings accumulated in post-1986 years preceding the year in which the section 902 ownership requirements are met) are treated as distributed only after the pools are exhausted, and then out of annual layers of earnings and taxes on a last-in, first-out basis. Distributions out of pre-1987 accumulated profits are governed by the section 902 rules in effect under pre-1987 law. Section 902(c)(6)(A).



The rule limiting the multi-year pools of earnings and taxes to post-1986 taxable years beginning with the year in which a foreign corporation first has a qualifying shareholder alleviates the administrative difficulties such shareholders face in reconstructing accumulated earnings and taxes accounts in connection with their acquisition of stock in a pre-existing foreign corporation. While section 902 provides that pooling of earnings and taxes begins only when the foreign corporation first has a qualifying shareholder entitled to compute a credit for deemed-paid taxes, the statute does not provide for any change in a foreign corporation's post-1986 undistributed earnings and taxes pools following a stock disposition or other transaction after which the foreign corporation no longer has a qualifying shareholder. Section 1.902-1(a)(13)(i) currently provides that, once a foreign corporation begins to maintain pools of earnings and taxes, the pools include periods during which the stock ownership requirements of section 902 are not met. Should such a corporation later again have a qualifying shareholder, such a shareholder would have to reconstruct the post-1986 undistributed earnings and taxes pools to include undistributed earnings and taxes for periods during which there was no qualifying shareholder, in order to compute deemed-paid credits with respect to distributions of earnings and profits accumulated during later periods in which the ownership requirements were met.

Treasury and the IRS believe that the policy concerns underlying the rule deferring the start of pooling until the corporation has a qualifying shareholder also apply to the situation where a foreign corporation once had, but no longer has, such a shareholder. Therefore, Treasury and the IRS believe it is appropriate to stop the multi-year pooling of earnings and taxes at the foreign corporation level when a foreign corporation no longer has a qualifying shareholder.

The proposed regulations would amend §1.902-1(a)(10) to provide that pre-1987 accumulated profits subject to the annual layering rules of pre-1987 law include not only the actual pre-1987 earnings and profits and pre-pooling earnings

and profits described in the current final regulation, but also formerly pooled earnings and profits of a less-than-10%-U.S.-owned foreign corporation attributable to post-1986 years during which the section 902 stock ownership requirements were met, and post-pooling earnings and profits accumulated during subsequent taxable years during which the foreign corporation did not have a qualifying shareholder. The formerly pooled earnings would be considered pre-1987 accumulated profits of the last taxable year of the foreign corporation as of the end of which the ownership requirements were met. Distributions out of formerly pooled earnings would be subject to the same pre-1987 law rules as distributions of other pre-1987 accumulated profits, except that the formerly pooled foreign income taxes related to the formerly pooled earnings would continue to be maintained in U.S. dollars. The proposed regulations would also amend §1.902-1(a)(13) to provide that pooling of earnings and taxes would resume in the first subsequent taxable year as of the end of which the foreign corporation again has a qualifying shareholder. Formerly pooled earnings would continue to be treated as pre-1987 accumulated profits even if the foreign corporation later began to maintain pools of earnings and taxes again.

Treasury and the IRS believe the proposed rules would be easier for taxpayers to apply than the current regulations, which require pooling to continue through periods when the foreign corporation has no shareholders entitled to compute a deemed-paid credit. These proposed amendments complement the proposed amendments to the section 904 regulations, described below, concerning the effect of intervening noncontrolled status on the look-through pools of post-1986 undistributed earnings and taxes maintained by a controlled foreign corporation. The proposed regulations also would be consistent with the approach taken in recently proposed amendments to the regulations under section 367(b) relating to the carryover of earnings and taxes accounts in reorganizations involving foreign corporations (REG-116050-99, 2000-48 I.R.B. 520, published in the **Federal Register** (65 FR 69138) on November 15, 2000).

## II. *Separate Categories: §1.904-4*

### A. *The active rents and royalties exception*

Section 1.904-4(b)(2) sets forth the active rents and royalties exception to the separate limitation for passive income. This exception currently applies only to payments from unrelated payors. Several commentators have requested that Treasury and the IRS amend the regulations to provide that royalties received from a member of the recipient's affiliated group (including foreign affiliates) may qualify for the exception if the royalties are derived in the conduct of an active trade or business and the payor uses the underlying property in an active trade or business. As explained below, Treasury and the IRS propose to adopt a modified version of the suggested change.

Section 904(d)(2)(A)(i) defines passive income as foreign personal holding company income, as defined in section 954(c). The section 904(d) active rents and royalties exception derives from section 954(c)(2)(A), which excludes from foreign personal holding company income, and thus from passive income, any rents or royalties derived in the active conduct of a trade or business and received from an unrelated person. The current final regulations at §1.904-4(b)(2)(ii) modify this exception to take into account activities of members of the recipient's affiliated group in determining whether the recipient meets the active trade or business prong of the test for section 904(d) purposes.

Treasury and the IRS have consistently declined to extend look-through treatment to payments from foreign non-controlled payors. See T.D. 8412 (1992-1 C.B. 271, 273). Treasury and the IRS continue to believe that the nature of the income earned by a foreign non-controlled payor from the use of the licensed property should not determine whether a rent or royalty payment constitutes income from the active conduct of a trade or business of the recipient.

However, Treasury and the IRS have decided that it is appropriate to eliminate the distinction between royalties received from related and unrelated payors in applying the active rents and royalties exception for purposes of section 904(d).

Therefore, these regulations propose to amend prospectively §1.904-4(b)(2) to provide that for purposes of section 904 (but not for purposes of section 954), the active rents and royalties exception will not require that the rents and royalties be received from an unrelated payor. This change is proposed to apply to rents and royalties paid or accrued more than 60 days after the date that these regulations are published in final form.

*B. Restriction of affiliated group special rule for active rents and royalties exception*

As noted, §1.904-4(b)(2)(ii) provides that, for purposes of the active rents and royalties exception from passive income under section 904, rents or royalties will be treated as derived in the active conduct of a trade or business by a United States person or controlled foreign corporation if any member of the recipient's affiliated group (defined to include foreign corporations) meets the requirements of section 954(c)(2)(A) with respect to the licensed property. The proposed regulations would amend the definition of affiliated group for purposes of §1.904-4(b)(2)(ii) to include only U.S. corporations and controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the stock (by vote and value). This requirement is consistent with the affiliated group rules of §1.904-4(e)(3)(ii), which consider the activities of other members of the affiliated group for purposes of determining whether an entity is a financial services entity. The proposed regulations revise the affiliated group rule in the active rents and royalties exception due to administrative concerns regarding the difficulty of determining whether related, but non-controlled, foreign corporations engage in the active conduct of a trade or business with respect to licensed property.

*C. Effect of intervening noncontrolled or less-than-10%-U.S.-owned status on distributions from a controlled foreign corporation or other look-through corporation*

Under section 904(d)(2)(E)(i) and §1.904-4(g)(3)(i), dividends from a controlled foreign corporation (CFC) are

treated as dividends from a noncontrolled section 902 corporation to the extent that the distribution is out of earnings and profits accumulated during periods in which the distributing corporation was not a CFC. Proposed §1.904-4(g)(3)(i)(C)(I) provides rules to address the effect of intervening noncontrolled status on the eligibility for look-through treatment of distributions of pre-2003 accumulations of pooled earnings and profits from a CFC. Consistent with the proposed amendments to §1.902-1(a) previously discussed, proposed §1.904-4(g)(3)(i)(C)(2) provides rules to address the effect of intervening less-than-10%-U.S.-owned status on the post-1986 undistributed earnings and taxes pools and pre-1987 accumulated profits of a foreign corporation and the application of the look-through rules to distributions from such a foreign corporation. The proposed regulations anticipate to some extent, but do not provide comprehensive guidance, regarding the changes to the statutory look-through rules for 10/50 companies that become effective for post-2002 taxable years. Additional conforming changes to the provisions of §§1.904-4 and 1.904-5 will be required to reflect the changes in terminology reflected in the proposed regulations that are necessitated by these statutory changes.

The proposed regulations provide that, when a CFC becomes a non-look-through 10/50 corporation (because it ceases to be controlled by United States shareholders, but has at least one qualifying shareholder, in a taxable year beginning before January 1, 2003), post-1986 undistributed earnings that were accumulated through the end of the taxable year preceding the taxable year in which the decontrolling event occurred and that were previously eligible for look-through treatment will be consolidated in, and constitute the opening balance of, a single non-look-through pool at the foreign corporation level. The regulations provide that distributions of the prior look-through earnings will continue to be treated as dividends from a non-look-through 10/50 corporation, and will not be eligible for look-through treatment, even if the foreign corporation later becomes a CFC again or becomes eligible for look-through treatment with respect to earnings accumulated in post-2002 taxable years.

Distributions of post-1986 undistributed earnings in the non-look-through pool will be treated as dividends from a non-look-through 10/50 corporation (10/50 dividend income) when distributed to a qualifying shareholder, or as passive income when distributed to any other shareholder. Pre-1987 accumulated profits distributed after a decontrolling event will similarly be treated as 10/50 dividend income or as passive income when distributed, depending on the status of, and the amount of stock owned by, the shareholder at the time of distribution. Because the separate limitation treatment of distributions during the taxable year is computed with reference to year-end pools of post-1986 undistributed earnings under section 902, the proposed regulations provide that distributions to a qualifying shareholder that are made in the taxable year in which a decontrolling event occurs are treated as 10/50 dividend income to qualifying shareholders, or passive income to other shareholders, whether made before or after the decontrolling event. Similarly, under §1.904-4(g)(3)(iii), earnings and profits accumulated in the year in which a foreign corporation becomes a CFC are treated as accumulated after the corporation became a CFC. Such earnings will be eligible for look-through treatment when distributed to a United States shareholder during the taxable year in which the distributing corporation becomes a CFC or during any subsequent taxable year until the distributing corporation ceases to be a CFC or other look-through corporation.

As noted, the proposed regulations do not permit look-through treatment for earnings and profits accumulated in pre-2003 taxable years while the distributing corporation was a CFC if the earnings are distributed after an intervening period ending before 2003 during which the corporation was not a CFC, even if the corporation is a CFC or other look-through corporation at the time of distribution. Earnings and profits previously eligible for look-through treatment will be placed in a single non-look-through pool with new earnings accumulated in taxable years beginning before January 1, 2003, while the corporation is not a CFC. The proposed rule would eliminate the need to determine whether distributions made while the corporation is a non-look-through 10/50 corporation (or, after 2002, a 10/50 look-through corporation) are

made out of look-through earnings accumulated in pre-2003 years prior to the decontrolling event or pre-2003 non-look-through earnings accumulated afterwards. Treasury and the IRS believe this rule would be simpler to apply with respect to pre-2003 periods during which the records necessary to establish look-through treatment are less likely to be maintained by a foreign corporation that is not controlled by United States shareholders.

This intervening noncontrolled status situation differs from the special situation described in §1.904-4(g)(3)(ii), which allows look-through treatment on distributions to a more-than-90-percent United States shareholder after August 6, 1997, of earnings and profits that were accumulated while the distributing corporation was a CFC. In the latter case, pre-acquisition post-1986 undistributed earnings of a CFC with a more-than-90-percent United States shareholder were required to be maintained in a non-look-through pool prior to the effective date of the amendment to section 904(d)(2)(E)(i) by TRA 1997. During the entire period the non-look-through pool was required to be maintained, the corporation was a CFC that was more-than-90-percent-owned by a single domestic corporation. Accordingly, the rules governing the effect of the 1997 repeal of the rule limiting look-through treatment to earnings accumulated while the more-than-90-percent United States shareholder was a United States shareholder of the distributing corporation do not provide an appropriate model for resolving the ongoing issue addressed by the proposed regulations.

Section 904(d)(4) as amended by section 1105(b) of TRA 1997 effective for taxable years beginning after December 31, 2002, will generally extend the look-through rules to distributions of earnings accumulated by a 10/50 company in post-2002 taxable years. Accordingly, non-look-through 10/50 corporations will not exist after 2002, although 10/50 look-through corporations will continue to maintain non-look-through pools of earnings and taxes accumulated in pre-2003 taxable years. Therefore, if the regulations are finalized prospectively, the effect of proposed §1.904-4(g)(3)(i)(C)(I) generally would be limited to situations

involving a CFC that is decontrolled after the regulations become final but before January 1, 2003, and to earnings that are accumulated in taxable years beginning before January 1, 2003, and that are not treated as distributed to the CFC's U.S. shareholders under section 1248 in connection with the decontrolling event. Comments are requested as to whether the simplification objectives of the regulation could best be met by extending the effective date to cover decontrolling events that occurred in prior periods.

Consistent with the proposed amendments to §1.902-1(a) and with the approach taken with respect to the pre-2003 decontrol situation, §1.904-4(g)(3)(i)(C)(2) of the proposed regulations provides that distributions out of formerly pooled earnings that are converted to an annual layer of pre-1987 accumulated profits when a foreign corporation no longer has a qualifying shareholder will be treated as distributions from a non-look-through 10/50 corporation, even if the foreign corporation later becomes a look-through corporation again.

The proposed regulations reserve on the treatment of distributions from a 10/50 look-through corporation, including the treatment of distributions out of earnings and profits accumulated in periods before the taxpayer acquired its stock. Comments are requested on whether additional guidance is needed to clarify the rules governing distributions from CFCs, and on how the regulations should be modified to reflect the rules of section 1105(b) of TRA 1997, extending look-through treatment to distributions from 10/50 corporations out of earnings and profits accumulated in post-2002 taxable years.

#### *D. Additional separate categories*

Treasury and the IRS propose to add a new paragraph (m) to §1.904-4, to provide that if section 904(a), (b), and (c) are applied separately to any category of income under the Code (for example, under section 901(j), 865(h), or 904(g)(10)), that category of income (additional category) will be treated for purposes of the Code and regulations (including, for example, section 904(f)) as if it were a separate category listed in sections 904(d)(1) and 904(d)(3)(F)(i). This amendment is intended to clarify the treatment of such additional separate categories without the need for

specific cross-references to such categories each time a provision refers to the separate categories listed in section 904(d). Sections 1.904-4(a) and 1.904-5(a)(1) are amended to include a reference to such additional separate categories.

### *III. Allocation and Apportionment of Taxes to Separate Categories: §1.904-6*

Treasury and the IRS propose to amend §1.904-6(a)(1) to clarify the rules for determining the amount of income (in each U.S. separate category) taxed by a foreign country, in situations in which foreign law does not provide expense allocation rules. In such cases, for purposes of determining the amount of income taxed by the foreign country in order to allocate and apportion foreign taxes to separate categories, a taxpayer must allocate the expenses that are deductible under foreign law using the same methods that the taxpayer uses to allocate expenses that are deductible under U.S. law for purposes of determining the amount of taxable income.

### *IV. Capital Gain and Loss Adjustments: §1.904(b)-1*

#### *A. Section 904(b) capital gain and loss adjustments*

The proposed regulations provide guidance regarding the rule of section 904(b)(2)(A) that foreign source capital gain may not exceed the lesser of capital gain net income from sources outside the United States or worldwide capital gain net income. A similar rule applies with respect to net capital gain. The regulations also provide guidance regarding the rule of section 904(b)(2)(B) that capital gains from foreign and U.S. sources, and capital losses from foreign sources, must be adjusted based on capital gain rate differential amounts. The proposed regulations exercise the regulatory authority granted under section 904(b)(2)(C) (authorizing regulations to modify the application of section 904(b)(2) and (3) to properly reflect capital gain rate differentials and the computation of net capital gain) and section 904(d)(6) (authorizing such regulations as may be necessary and appropriate for the purposes of section 904(d)).



The proposed regulations first provide guidance concerning the adjustments required when foreign source capital gains exceed the lesser of capital gain net income (or net capital gain) from sources outside the United States or capital gain net income (or net capital gain) from all sources. Section 904(b)(2)(A) and section 904(b)(2)(B)(i) provide that, for purposes of section 904, foreign source capital gains that are included in foreign source taxable income may not exceed the lesser of capital gain net income from sources outside the United States or capital gain net income from all sources. Section 904(b)(2)(A), (3)(A). Similar rules apply for purposes of determining foreign source net capital gain. Section 904(b)(3)(B). After the 1986 enactment of separate limitation categories in section 904(d), the issue arises as to the extent to which foreign source capital gains should be adjusted if the taxpayer has foreign source capital gains and losses in more than one separate category.

The proposed regulations provide that foreign source capital gains included in foreign source taxable income in any separate category are reduced by reason of section 904(b)(2)(A) and section 904(b)(2)(B)(i) only by foreign source capital losses in the same separate category and by a ratable portion of the excess of capital gain net income from foreign sources (in the aggregate, considering all of the taxpayer's separate categories) over capital gain net income from all sources (considering capital gains and losses from sources within and outside the United States, from all of the taxpayer's separate categories). Thus, the proposed rule would reduce capital gain net income from foreign sources in any separate category only if the taxpayer has a net U.S.-source capital loss, and not in instances where foreign-source capital gains in one separate category are offset only by foreign-source capital losses from another separate category. This rule implements Congress's intent that section 904(b)(2)(A) and section 904(b)(2)(B)(i) should prevent foreign-source capital gains from inappropriately increasing the numerator of the foreign tax credit limitation fraction under section 904(a) if those capital gains were offset by U.S.-source capital losses, while avoiding the potential

for double counting of foreign-source losses that might result if foreign-source gains in one separate category were reduced by reason of foreign-source losses that reduce ordinary income in another separate category.

The regulations further provide that if the taxpayer's capital gain net income from sources outside the United States exceeds the taxpayer's capital gain net income from all sources (*i.e.*, where there is a net U.S. capital loss), a *pro rata* portion of such excess reduces the capital gain net income from sources outside the United States in each of the taxpayer's separate limitation categories and, within each separate category, in each rate group. The *pro rata* portion is determined based on the relative amounts of net capital gain from sources outside the United States in each separate category or rate group.

In addition, the proposed regulations provide guidance on adjusting capital gains and foreign capital losses to reflect capital gain rate differentials. Section 904(a) limits the foreign tax credit to the lesser of 1) foreign tax paid or accrued; or 2) pre-credit U.S. tax multiplied by a fraction equal to foreign source taxable income over worldwide taxable income (the limitation fraction). Multiplying the pre-credit U.S. tax by the limitation fraction is meant to determine the portion of U.S. taxes that are attributable to foreign source income. Section 904(b)(2)(B) adjusts capital gains in the numerator and denominator, and foreign source capital losses in the numerator, of the limitation fraction if capital gains are taxed at lower rates than ordinary income, as is often the case under current law for individuals. Unless capital gains and foreign capital losses are adjusted to account for this difference, the limitation fraction will not accurately reflect the portion of the total pre-credit U.S. tax that is properly attributable to foreign source income.

The rate differential adjustments to capital gains and foreign source capital losses, under section 904(b) and the proposed regulations, apply only if the specific taxpayer has net capital gain that is subject to reduced tax rates for the taxable year. Treasury and the IRS request comments with respect to applying on an elective basis adjustments based on rate differentials for taxable years in which the

Code applies reduced tax rates to capital gains generally, but the specific taxpayer has capital losses that equal or exceed capital gains. Any such elective rule would need to include ordering rules for determining the source, the separate category, and the rate group of the capital losses that are taken into account for the current taxable year, including those capital losses that are currently deductible to the extent of \$3,000 under section 1211(b) against ordinary income, and those losses that are subject to the capital loss carry-over rules.

As noted, section 904(b)(2)(C) grants regulatory authority to modify the application of section 904(b)(2) and (3) "to the extent necessary to properly reflect any capital gain rate differential under section 1(h) or 1201(a) and the computation of net capital gain." The proposed regulations exercise this authority and adjust the section 904(b)(2)(B) calculations to reflect the fact that, for taxable years ending after May 6, 1997, section 1(h) contains multiple capital gains rates. The proposed regulations thus require that capital gain net income, from sources outside the United States and from all sources, must be adjusted pursuant to section 904(b)(2)(B)(i) and (ii) by the rate differential portion of each rate group of the taxpayer's net capital gain from sources outside the United States and from all sources, respectively.

The proposed regulations also provide guidance on adjusting foreign source capital losses under section 904(b)(2)(B)(iii). The regulations clarify that such capital losses (after netting against foreign source capital gains in the same rate group, as defined in the regulations) should be reduced based on the tax rate applicable under section 1(h) to the net capital gains that are offset by such net capital losses in the determination of the taxpayer's taxable income. Although section 904(b)(2)(B)(iii) provides for such adjustment in instances when net foreign losses have offset U.S. source capital gains, the existence of multiple separate categories after 1986 may result in foreign source capital gains and losses in separate categories offsetting one another. Therefore, the regulations require adjustment of foreign capital losses that offset foreign source capital gains associated with dif-



ferent capital gains rates, in addition to foreign capital losses that offset U.S. source capital gains.

In determining which capital gains are offset by capital losses from sources outside the United States in different rate groups, the proposed regulations provide that net capital losses from sources within the United States will not be taken into account, in order to simplify this determination. Treasury and the IRS request comments regarding whether the regulations should take net capital losses from sources within the United States into account for such purposes, and, if so, what type of ordering rules should be applied.

The IRS is considering providing a simplified worksheet for performing the section 904(b)(2)(B) adjustments in the Form 1116 instructions, for taxpayers whose capital gains are subject only to 10 or 20 percent tax rates under section 1(h) (similar to the simplified worksheet provided in the 1999 Form 1040 instructions as an alternative to Schedule D for taxpayers whose capital gains are subject only to 10 and 20 percent tax rates under section 1(h)). Treasury and the IRS request comments on this approach.

#### *B. Appropriate tax rates for AMT foreign tax credit calculation*

The proposed regulations provide that the alternative minimum tax (AMT) rates, rather than the regular tax rates, apply for purposes of carrying out the section 904(b) capital gains rates adjustments for the AMT foreign tax credit. Section 904(b) generally adjusts capital gains and foreign source capital losses based on the difference between the maximum U.S. tax rate and the tax applicable to capital gains under section 1(h). This adjustment is necessary to calculate more accurately the amount of U.S. tax that is attributable to foreign source income (as determined by application of the section 904(a) fraction). Section 59(a)(1)(B) provides that the AMT foreign tax credit must be determined as if "section 904 were applied on the basis of alternative minimum taxable income," and therefore requires the application of section 904(b) in determining the AMT foreign tax credit. In order to reflect more accurately the amount of pre-credit tentative minimum tax attributable to foreign source AMT income, these reg-

ulations provide that, for purposes of applying section 904(b) in determining the AMT foreign tax credit, the maximum AMT rates should be used rather than the rates specified in section 1.

In addition, the regulations clarify that section 904(b)(2)(B)(ii) (relating to capital gains from all sources), as well as section 904(b)(2)(B)(i) and (iii) (relating to foreign source capital gains and losses, respectively) apply (in modified form, as provided in section 59) to the determination of the AMT foreign tax credit. The regulations also clarify that section 904(b) applies to taxpayers electing to apply the simplified foreign tax credit limitation rules under section 59(a)(4).

#### *V. Coordination of Section 904(j) with Carryforward and Carryback Rules: §1.904(j)*

Section 904(j) allows a taxpayer to elect not to apply section 904(a) (the foreign tax credit limitation fraction) if the taxpayer's creditable foreign taxes paid or accrued for the year are \$300 or less (\$600 or less for joint filers), the taxpayer's foreign source gross income consists entirely of passive income, and such income and taxes are reported to the taxpayer on a payee statement. If a taxpayer elects to apply section 904(j) for any taxable year, no foreign taxes paid or accrued in such year may be carried over to any other year, and no foreign taxes paid or accrued in any other year may be carried over to the section 904(j) election year.

The proposed regulations clarify that a taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes paid or accrued for the taxable year and for which a credit is allowable to the taxpayer under section 901 for the taxable year are creditable foreign taxes (as defined in section 904(j)(3)(B)). For example, suppose that in year 2, the taxpayer accrues and pays foreign tax that was not shown on a payee statement furnished to the taxpayer and that is related to general limitation income that was recognized and included in income for U.S. tax purposes in year 1. If the foreign taxes in the general limitation category are creditable under section 901 for year 2, the taxpayer may not elect to apply section 904(j) for year 2, even if all of the taxpayer's income in year 2 is qualified passive income.

In addition, taxpayers requested clarification on the application of the carryover provisions in taxable years following section 904(j) election years. Because high-taxed income, as defined in section 904(d)(2)(F), is calculated by reference to the highest rate of tax specified in section 1 or 11 (whichever is applicable), Treasury and the IRS expect that some individual taxpayers who are eligible to elect the application of section 904(j) may have foreign tax credit carryovers in the passive income category.

The proposed regulations clarify that the amount of a foreign tax credit carryover to or from a non-section-904(j)-election year is not reduced to account for the part of the carryover that (but for section 904(j)) could have been used in intervening section 904(j)-election years. Section 904(j) was intended to allow taxpayers to avoid computing the section 904(a) limitation fraction. See Committee on the Budget, U.S. House of Representatives, Report on Revenue Reconciliation Act of 1997, June 24, 1997, at 520-21. Requiring taxpayers to compute the amount of carryover that could have been used in the election year would be inconsistent with the statutory purpose of making the credit provisions less complex and less burdensome for taxpayers with small amounts of solely passive foreign-source income reported on payee statements. (Taxpayers may, of course, choose to perform the calculations to determine whether electing the application of section 904(j) would be more advantageous for them, particularly for years in which a foreign tax credit carryover will expire.)

However, the section 904(j) election does not extend the carryforward and carryback periods under section 904(c). For example, if a carryforward expires in 2000, and the taxpayer elects the application of section 904(j) for the 2000 taxable year, the carryforward cannot be used in 2000 (pursuant to section 904(j)(1)(C)) or in any later year (pursuant to the expiration of the carryforward period).

Similarly, the determination of whether the taxpayer paid or accrued more than \$300 (or \$600) of creditable foreign taxes is made without regard to carryovers. For example, a single taxpayer who pays \$300 of creditable foreign taxes in 2001, and has a \$500 carryover to 2001 from a pre-

vious year, is eligible to elect the application of section 904(j) for the 2001 year. However, if the election is made, the taxpayer cannot claim a credit in 2001 for the \$500 otherwise treated as a carryover.

#### VI. Removal of Example in §1.954-2

The proposed regulations remove Example 2 under §1.954-2(b)(2)(iv), which was intended to illustrate the application of the rules under §1.954-2(b)(2) for the exception from foreign personal holding company for certain export financing interest. Treasury and the IRS are concerned that the example may be unintentionally confusing. For this reason, it is being removed. Comments are invited concerning whether a replacement example is necessary.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 26, 2001, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building

security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 5, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### Drafting Information

The principal author of these proposed regulations is Rebecca I. Rosenberg of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and Treasury participated in their development.

\* \* \* \* \*

#### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "Section 1.902-1 and 902-2" and §1.904-4 through 1.904-7", and adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*  
Section 1.902-1 also issued under 26

U.S.C. 902(c)(7). \* \* \*

Section 1.904-4 also issued under 26 U.S.C. 904(b)(2)(C) and 904(d)(5).

Section 1.904-5 also issued under 26 U.S.C. 904(d)(5).

Section 1.904-6 also issued under 26 U.S.C. 904(d)(5).

Section 1.904-7 also issued under 26 U.S.C. 904(d)(5). \* \* \*

Par. 2. Section 1.902-0 is amended by:

1. Revising the entry for §1.902-1(a)(13)(ii).

2. Adding an entry for §1.902-1(a)(13)(iii).

The revisions and additions read as follows:

*§1.902-0 Outline for regulations provisions for section 902.*

\* \* \* \* \*

*§1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.*

(a) \* \* \*

(13) \* \* \*

(ii) Resumption of pooling.

(iii) Examples.

\* \* \* \* \*

Par 3. Section 1.902-1 is amended as follows:

1. Paragraph (a)(8)(ii) is amended by revising the second sentence.

2. Paragraph (a)(10)(i) is revised.

3. Paragraph (a)(10)(iii) is amended by revising the last sentence and adding one sentence.

4. Paragraphs (a)(13)(i)(A) and (a)(13)(i)(B) are revised.

5. Paragraphs (a)(13)(i)(C) and (a)(13)(i)(D) are added.

6. Paragraph (a)(13)(ii) is revised.

7. Paragraph (a)(13)(iii) is added.

The revisions and additions read as follows:

*§1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.*

(a) \* \* \*

(8) \* \* \*

(ii) \* \* \* Foreign income taxes (other than taxes attributable to formerly pooled earnings that are maintained in United States dollars) that are deemed paid with

respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. \* \* \*

\* \* \* \* \*

(10) \* \* \* (i) The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987 (pre-1987 earnings). If the special effective date of paragraph (a)(13)(i) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with section 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to that corporation (pre-pooling earnings). Pre-1987 accumulated profits also includes any post-1986 undistributed earnings formerly maintained by a less-than-10%-U.S.-owned foreign corporation (as defined in §1.904-4(g)(1)) that are attributable to the foreign corporation's taxable years beginning after December 31, 1986, as of the end of which such ownership requirements were met (formerly pooled earnings). Such formerly pooled earnings shall be considered pre-1987 accumulated profits of the last taxable year of the foreign corporation in which such ownership requirements were met as of the end of the taxable year. Pre-1987 accumulated profits also includes earnings and profits accumulated during subsequent taxable years of such a less-than-10%-U.S.-owned foreign corporation as of the end of which such ownership requirements were not met (post-pooling earnings). All four types of pre-1987 accumulated profits described in this paragraph (a)(10)(i) are also sometimes referred to as pre-pooling annual layers.

\* \* \* \* \*

(iii) \* \* \* Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United

States dollars at the spot exchange rate in effect on the date of the distribution, except that foreign income taxes attributable to formerly pooled earnings described in the third sentence of paragraph (a)(10)(i) of this section shall be maintained in United States dollars as originally translated in accordance with section 986(a). Post-1986 foreign income taxes attributable to such formerly pooled earnings shall be treated as pre-1987 foreign income taxes.

\* \* \* \* \*

(13) \* \* \* (i) \* \* \*

(A) The post-1986 undistributed earnings and post-1986 undistributed foreign income taxes of the foreign corporation shall be determined by taking into account only consecutive taxable years beginning on and after the first day of the first taxable year of the foreign corporation as of the end of which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met and ending before the first day of a subsequent taxable year in which such ownership requirements are not met as of the end of the taxable year;

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation as of the end of which such ownership requirements are met shall be considered pre-1987 accumulated profits (which may include both pre-pooling earnings and pre-1987 earnings);

(C) Formerly pooled earnings described in paragraph (a)(10)(i) of this section shall be considered pre-1987 accumulated profits of the taxable year ending immediately before the next taxable year in which such ownership requirements are not met as of the end of the taxable year; and

(D) Earnings and profits accumulated on and after the first day of a taxable year of the foreign corporation as of the end of which such ownership requirements are not met shall be considered pre-1987 accumulated profits (post-pooling earnings).

(ii) *Resumption of pooling.* If the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are again met with respect to a foreign corporation that originally maintained pools of post-1986 undistributed earnings and post-1986 for-

eign income taxes but converted such pools to pre-1987 accumulated profits (formerly pooled earnings) and associated pre-1987 foreign income taxes because such ownership requirements were not met as of the close of a subsequent post-1986 taxable year, then the post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first such subsequent taxable year of the foreign corporation as of the end of which such ownership requirements are met and ending before the first day of a subsequent taxable year in which such ownership requirements are not met as of the end of the taxable year. The post-pooling earnings, formerly pooled earnings, pre-pooling earnings, and pre-1987 earnings of such a foreign corporation shall continue to be considered pre-1987 accumulated profits. The rules of paragraph (a)(13)(i)(B) through (D) of this section shall apply if such a foreign corporation again becomes a less-than-10%-U.S.-owned foreign corporation.

(iii) *Examples.* The following examples illustrate the special effective date rules of this paragraph (a)(13):

*Example 1.* As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the U.S. dollar. Assume 1u equals \$1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to \$100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all subsequent taxable years beginning before the date these regulations are published as final regulations in the **Federal Register**, as well as later taxable years as of the end of which the ownership requirements of section 902(c)(3)(B) and paragraphs



(a)(1) through (4) of this section are met. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u - 200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has \$60 (\$100- [\$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

*Example 2.* The facts are the same as in *Example 1*, except that Corporation M sells five percent of the Corporation B stock to an unrelated buyer on July 1, 2003, so that Corporation B no longer meets the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section as of that date. Thus, as of December 31, 2003, Corporation B's earnings and profits all consist of pre-1987 accumulated profits, comprising pre-1987 earnings for years beginning prior to January 1, 1987, pre-pooling earnings for taxable years 1987 through 1991, no earnings for 1992 through 2001, formerly pooled earnings for 2002 (comprising Corporation B's post-1986 undistributed earnings for 1992 through 2002), and post-pooling earnings for 2003. Dividends paid by Corporation B to Corporation M at any time during 2003 will be considered paid out of pre-1987 accumulated profits. See paragraphs (a)(10) and (a)(13)(i) of this section. However, Corporation M will be eligible to claim a deemed-paid credit only with respect to dividends received on or before July 1, 2003. See paragraphs (a)(1) and (12) of this section and §1.902-3(a)(1) and (7).

*Example 3.* The facts are the same as in *Example 2*, except that Corporation M purchases an additional five percent of the stock of Corporation B on July 1, 2004, so that Corporation B again meets the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section on December 31, 2004. As of the end of 2004, assume Corporation B has 500u of post-1986 undistributed earnings (after foreign taxes but before taking into account distributions during 2004) and \$100 of post-1986 foreign income taxes attributable to 2004, 500u of post-pooling earnings and 100u of pre-1987 foreign income taxes attributable to 2003, and 1500u of formerly pooled earnings and \$250 of pre-1987 foreign income taxes attributable to 2002 (comprising Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes for 1992 through 2002). Corporation B pays dividends to its shareholders of 500u on March 1, 2004, and 500u on September 1, 2004. The March 1, 2004, dividend is out of Corporation B's post-1986 undistributed earnings in its entirety, and reduces Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes to zero, even though no shareholder is eligible to claim a credit for deemed-paid taxes. See paragraphs (a)(8)(i) and (b)(1) of this section. The September 1, 2004, dividend is out of 2003 post-pooling earnings, and reduces 2003 post-pooling earnings and foreign income taxes to zero. Corporation M, which is a 10% domestic shareholder of Corporation B on that date and receives a dividend of 50u, is deemed to have paid 10u of foreign

income taxes (50u/500u x 100u) with respect to the dividend. Both the dividend and the deemed-paid taxes are translated into dollars at the spot exchange rate on the dividend date, under the law in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10)(i) and (ii) of this section.

Par. 4. Section 1.904-0 is amended as follows:

1. The entries for §1.904-4 are amended by:

a. Revising the entry for paragraph (b)(2)(iii).

b. Removing the entry for paragraph (b)(2)(iv).

c. Revising the entries for paragraph (g) and (g)(1), adding entries for paragraph (g)(1)(i) through (g)(1)(iii), and revising the entry for paragraph (g)(3)(i)(C).

d. Adding entries for paragraphs (g)(3)(i)(C)(1), (g)(3)(i)(C)(2), and (g)(4).

e. Adding an entry for paragraph (m).

2. The entries for §1.904(b)-1 are amended by:

a. Revising section heading and the entries for all of paragraphs (a), (b), and (c).

b. Adding entries for paragraphs (d), (e), (f), (g), and (h).

3. Revising the entries for all of §1.904(b)-2.

4. Removing all the entries for §§1.904(b)-3 and 1.904(b)-4.

5. Adding entries for §1.904(j)-1.

The revisions and additions read as follows:

#### *§1.904-0 Outline of regulation provisions for section 904.*

\* \* \* \* \*

#### *§1.904-4 Separate application of section 904 with respect to certain categories of income.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(iii) Example.

\* \* \* \* \*

(g) Noncontrolled section 902 corporation and non-look-through 10/50 corporation.

(1) Corporate-level accounts and treatment of distributions to shareholders.

(i) Definitions.

(ii) Accounts at foreign corporation level.

(iii) Inclusion at shareholder level.

\* \* \* \* \*

(3) \* \* \*

(i) \* \* \*

(C) Effect of intervening noncontrolled or less-than-10%-U.S.-owned status.

(1) Pre-2003 decontrolling event.

(2) Pool-terminating event.

\* \* \* \* \*

(4) Special rule for dividends paid by a 10/50 look-through corporation.

\* \* \* \* \*

(m) Income treated as allocable to an additional separate category.

\* \* \* \* \*

#### *§1.904(b)-1 Special rules for capital gains and losses.*

(a) Capital amounts included in taxable income from sources outside the United States.

(1) Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States.

(i) In general.

(ii) Allocation of reduction among multiple separate categories or rate groups.

(2) Capital losses from sources outside the United States in the same separate category.

(3) Exclusivity of rules; no reduction by reason of net capital loss from sources outside the United States in a different separate category.

(4) Examples.

(b) Capital gain rate differential.

(1) Application of adjustments only if capital gain rate differential exists.

(2) Determination of whether capital gain rate differential adjustment exists.

(c) Rate differential adjustment of capital gains.

(1) Rate differential adjustment of capital gains in foreign source taxable income.

(2) Rate differential adjustment of capital gains in entire taxable income.

(d) Rate differential adjustment of capital losses from sources outside the United States.

(1) In general.

(2) Determination of which net capital gains are offset by net capital losses from sources outside the United States.

(e) Definitions.

(1) Alternative tax rate.

(2) Capital gain net income.



- (3) Net capital gain.
- (4) Rate group.
- (i) Capital gains.
- (ii) Capital losses.
- (5) Terms used in sections 1(h), 904(b) or 1222.
- (f) Examples.
- (g) Coordination with overall foreign loss recapture rules.
- (h) Effective date.

*§1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.*

- (a) Application of section 904(b)(2)(B) adjustments.
- (b) Use of alternative minimum tax rates.
- (1) Taxpayers other than corporations.
- (2) Corporate taxpayers.
- (c) Effective date.

\* \* \* \* \*

*§1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.*

- (a) Election available only if all foreign taxes are creditable foreign taxes.
- (b) Coordination with carryover rules.
- (1) No carryovers to or from election year.
- (2) Carryovers to and from other years determined without regard to election years.
- (3) Determination of amount of creditable foreign taxes.
- (c) Examples.

Par. 5. Section 1.904–4 is amended as follows:

- 1. Paragraph (a) is amended by removing the period at the end and adding the language “, or in §1.904–4(m) (additional separate categories).”
- 2. The first sentence of paragraph (b)(2)(i) is revised.
- 3. Paragraph (b)(2)(ii) is revised.
- 4. Paragraph (b)(2)(iii) is removed.
- 5. Paragraph (b)(2)(iv) is redesignated as paragraph (b)(2)(iii).
- 6. The last three sentences of the *Example* in newly designated paragraph (b)(2)(iii) are revised and three new sentences are added at the end.
- 7. The paragraph heading for paragraph (g) is revised.
- 8. Paragraph (g)(1) is redesignated as paragraph (g)(1)(i) and a new heading is added for paragraph (g)(1).

9. Five sentences are added at the end of newly designated paragraph (g)(1)(i).

10. Paragraphs (g)(1)(ii) and (iii) are added.

11. The heading of paragraph (g)(3)(i)(C) is revised and the text to paragraph (g)(3)(i)(C) is added.

12. The text of *Example 2* through *Example 4* is added to paragraph (g)(3)(i)(D).

13. Paragraph (g)(4) is added.

14. The language “and” at the end of paragraph (l)(1)(v) is removed.

15. The period at the end of paragraph (l)(1)(vi) is removed and “; and” is added in its place.

16. Paragraph (l)(1)(vii) is added.

17. Paragraph (m) is added.

The revisions and additions read as follows:

*§1.904–4 Separate application of section 904 with respect to certain categories of income.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \* (i) \* \* \* For rents and royalties paid or accrued more than 60 days after the date these regulations are published as final regulations in the **Federal Register**, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. \* \* \*

(ii) *Exception for certain rents and royalties.* Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(ii), an affiliated group includes only United States corporations and foreign corporations that are controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and

value of the stock. For purposes of this paragraph (b)(2)(ii), indirect ownership shall be determined under section 318 and the regulations under that section.

(iii) \* \* \*

*Example.* \* \* \* Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S’s country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations thereunder. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general limitation income to S under §1.904–4(b)(2)(ii) because P, a member of S’s affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S’s royalty income that is taxable to P under subpart F and the royalties paid to P are general limitation income to P under the look-through rules of §1.904–5(c)(1)(i) and (c)(3), respectively.

\* \* \* \* \*

(g) *Noncontrolled section 902 corporation and non-look-through 10/50 corporation—(1) Corporate-level accounts and treatment of distributions to shareholders—(i) Definitions.* \* \* \* Except as otherwise provided, the term “look-through corporation” means a foreign corporation that is subject to the look-through rules of section 904(d)(3) or section 904(d)(4) (as in effect for taxable years beginning after December 31, 2002). The term “non-look-through 10/50 corporation” means any foreign corporation that is not a look-through corporation and with respect to which a domestic corporation meets the stock ownership requirements of section 902(a), or, for purposes of applying the look-through rules described in section 904(d)(3) and §1.904–5, a domestic corporation meets the requirements of section 902(b). The term “less-than-10%-U.S.-owned foreign corporation” means a foreign corporation that is neither a look-through corporation nor a non-look-through 10/50 corporation. The term “look-through pool” means the post-1986 undistributed earnings of a foreign corporation that are subject to the look-through provisions of section 904(d)(3) or section 904(d)(4) as in effect for taxable years beginning after December 31, 2002. The term “non-look-through pool” means the post-1986 undis-

tributed earnings of a foreign corporation that were accumulated (or treated as accumulated) while the foreign corporation was a non-look-through 10/50 corporation.

(ii) *Accounts at foreign corporation level.* The post-1986 undistributed earnings of a controlled foreign corporation or other look-through corporation may consist of look-through pools (comprising post-1986 undistributed earnings accumulated during periods when the foreign corporation was, or was treated as, a look-through corporation, which may include post-1986 undistributed earnings in one or more non-look-through pools attributable to dividends paid to the look-through corporation by each separate non-look-through 10/50 corporation), as well as one or more non-look-through pools (including post-1986 undistributed earnings accumulated during periods when the foreign corporation was, or was treated as, a non-look-through 10/50 corporation). Similarly, a look-through corporation's pre-pooling annual layers, as defined in §1.902-1(a)(10)(i), may or may not be subject to the look-through rules, depending on whether the corporation was, or was treated as, a look-through corporation at the time the earnings were accumulated.

(iii) *Inclusion at shareholder level.* A particular dividend recipient will be entitled to look-through treatment with respect to a particular distribution from a controlled foreign corporation only if the recipient is a United States shareholder, as defined in section 951(b) taking into account section 953(c), of the controlled foreign corporation at the time it receives the dividend. Therefore, a dividend distribution from a controlled foreign corporation to a United States shareholder will be characterized under the look-through rules, whereas a dividend distribution to a less-than-10% shareholder of the controlled foreign corporation will be treated as passive income. Similarly, under section 904(d)(1)(E), only a corporate shareholder calculates a separate foreign tax credit limitation for dividends from each noncontrolled section 902 corporation, and the look-through rules of section 904(d)(4) as in effect for taxable years beginning after December 31, 2002, apply only to applicable dividends out of post-2002 earnings of a corporation that is a

noncontrolled section 902 corporation with respect to the taxpayer. Therefore, dividends paid to an individual shareholder by a non-look-through 10/50 corporation, or by a controlled foreign corporation out of a non-look-through pool, will be treated as passive income. Similarly, dividends paid to an individual shareholder by a look-through corporation that is not a controlled foreign corporation will be treated as passive income to such individual, even if the individual owns 10 percent or more of the distributing corporation's stock.

\* \* \* \* \*

(3) \* \* \*

(i) \* \* \*

(C) *Effect of intervening noncontrolled or less-than-10%-U.S.-owned status—(1) Pre-2003 decontrolling event.* If a controlled foreign corporation becomes a non-look-through 10/50 corporation, for example, by reason of the corporation's issuance of additional stock or the disposition of stock by the corporation's controlling United States shareholders to foreign persons in a taxable year of the controlled foreign corporation beginning before January 1, 2003, (a decontrolling event), and retains that status as of the end of the foreign corporation's taxable year, then earnings and profits that were accumulated before the decontrolling event during periods when the corporation was a controlled foreign corporation will at all times thereafter be treated as earnings and profits accumulated by a non-look-through 10/50 corporation. The corporation's post-1986 undistributed earnings (or deficits in post-1986 undistributed earnings) in each separate category shall be combined into, and constitute the opening balance of, a single non-look-through pool of post-1986 undistributed earnings accumulated in taxable years beginning before January 1, 2003. The corporation's post-1986 foreign income taxes in each separate category shall similarly be combined into a single category of post-1986 foreign income taxes attributable to the non-look-through pool. Distributions of such earnings and profits after the decontrolling event will not be subject to the look-through rules of §1.904-5, even if the corporation subsequently becomes a controlled foreign corporation or other look-through corporation again. The corporation's pre-1987 accumulated profits will also be ineligible for look-through treatment if accumu-

lated prior to, and distributed after, the decontrolling event. In determining whether the look-through rules apply to earnings and profits maintained at the distributing corporation level, earnings and profits accumulated or distributed in the taxable year in which a decontrolling event occurs shall be considered accumulated or distributed after the decontrolling event, respectively. However, in determining whether a dividend recipient is entitled to look-through treatment with respect to a particular distribution, only the shareholder's status and ownership of stock at the time it receives the dividend is relevant. See §1.902-1(a)(1) and paragraph (g)(1)(iii) of this section.

(2) *Pool-terminating event.* If a look-through corporation or a non-look-through 10/50 corporation becomes a less-than-10%-U.S.-owned foreign corporation, for example, by reason of the corporation's issuance of additional stock or the disposition of stock by the corporation's United States shareholders (a pool-terminating event), and retains that status as of the end of the foreign corporation's taxable year, then earnings and profits that were accumulated before the pool-terminating event will at all times thereafter be treated as pre-1987 accumulated profits accumulated by a non-look-through 10/50 corporation in accordance with §1.902-1(a)(10) and (13). Distributions of such earnings and profits after the pool-terminating event will not be subject to the look-through rules of §1.904-5, even if the corporation subsequently becomes a look-through corporation again. Earnings and profits accumulated or distributed in the taxable year in which a pool-terminating event occurs shall be considered accumulated or distributed after the pool-terminating event, respectively. However, in determining whether a dividend recipient is entitled to look-through treatment with respect to a particular distribution, only the shareholder's status and ownership of stock at the time it receives the dividend is relevant. See §1.902-1(a)(1) and paragraph (g)(1)(iii) of this section.

\* \* \* \* \*

(D) \* \* \*

*Example 2.* (i) *Facts.* X, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. On March 1, 2002, S pays a dividend to X. On July 1, 2002, S issues additional shares of stock to Z, a foreign person, in exchange for a capital contribution. The new stock issuance dilutes X's inter-

est in S to 40 percent. Thus, S is a non-look-through 10/50 corporation beginning on July 1, 2002.

(ii) *Result.* The March 1, 2002, dividend to X is treated as a dividend from a non-look-through 10/50 corporation. X is not entitled to look-through treatment on the dividend under paragraph (g)(3)(i)(C) of this section.

*Example 3.* (i) *Facts.* X, a domestic corporation, has owned all of the stock of S, a controlled foreign corporation, since S was organized in 1980. Both X and S use the calendar year as the taxable year. On July 1, 2002, X sells 60 percent of the stock of S to Z, a foreign person. On July 1, 2003, X repurchases all of the S stock that it sold to Z in 2002. Thus, S is a controlled foreign corporation for 1980 through June 30, 2002, a non-look-through 10/50 corporation from July 1, 2002, through December 31, 2002, and a look-through corporation from January 1, 2003, forward, as well as a controlled foreign corporation from July 1, 2003, forward.

(ii) *Result.* Pursuant to paragraph (g)(3)(i)(C) of this section, X is entitled to look-through treatment with respect to distributions before January 1, 2002, of S's post-1986 undistributed earnings accumulated through December 31, 2001, and of S's pre-1987 accumulated profits. Distributions after December 31, 2001, of earnings and profits accumulated before January 1, 2003, will be treated as dividends from a non-look-through 10/50 corporation. X is entitled to look-through treatment on distributions of earnings and profits accumulated and distributed after December 31, 2002.

*Example 4.* (i) *Facts.* The facts are the same as in *Example 3*, except that X sells 95 percent, rather than 60 percent, of the stock of S to Z. Thus, S is a controlled foreign corporation for 1980 through June 30, 2002, a less-than-10%-U.S.-owned foreign corporation from July 1, 2002, through June 30, 2003, and a controlled foreign corporation beginning on July 1, 2003.

(ii) *Result.* The result is the same as in *Example 3*, except that distributions from S made between July 1, 2002, and June 30, 2003, will be treated as passive income to X because X owns less than 10 percent of the stock of S during that period. Distributions from S to X made between January 1, 2002, and June 30, 2002, will be treated as dividends from a non-look-through 10/50 corporation. Distributions from S to X made after June 30, 2003, out of earnings and profits accumulated prior to January 1, 2003, will be treated as dividends from a non-look-through 10/50 corporation. X is entitled to look-through treatment of distributions after June 30, 2003, out of earnings and profits accumulated after December 31, 2002.

\*\*\*\*\*

(4) *Special rule for dividends paid by a 10/50 look-through corporation.*  
[Reserved]

\*\*\*\*\*

(1) \*\*\* (1) \*\*\*

(vii) Income that meets the definitions of a separate category described in paragraph (m) of this section and of any other category of separate limitation income described in section 904(d)(1)(A) through (H) will be subject to the separate limita-

tion described in paragraph (m) of this section and will not be treated as general limitation income described in section 904(d)(1)(I).

\*\*\*\*\*

(m) *Income treated as allocable to an additional separate category.* If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(g)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1) and section 904(d)(3)(F)(i).

Par. 6. In §1.904-5, paragraph (a)(1) is revised to read as follows:

*§1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.*

(a) \*\*\*

(1) The term "separate category" means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (E), (F), (G), (H), or (I) and in §1.904-4(b), (d), (e), (f), and (g), any category of income described in §1.904-4(m), or any category of earnings and profits to which income described in such provisions is attributable.

\*\*\*\*\*

Par. 7. In §1.904-6, paragraph (a)(1)(ii) is amended by adding two sentences at the end to read as follows:

*§1.904-6 Allocation and apportionment of taxes.*

(a) \*\*\* (1) \*\*\*

(ii) \*\*\* If the taxpayer applies the principles of §§1.861-8 through 1.861-14T for purposes of allocating expenses at the level of the taxpayer (or at the level of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes) under this paragraph (a)(1)(ii), such principles shall be applied (for such purposes) in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for United States tax purposes of the taxpayer (or of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes, as the case may be). For

example, a taxpayer must use the modified gross income method under §1.861-9T when applying the principles of that section for purposes of this paragraph (a)(1)(ii) to determine the amount of a controlled foreign corporation's income, in each separate category, that is taxed by a foreign country, if the taxpayer applies the modified gross income method under §1.861-9T(f)(3) when applying §1.861-9T to determine the income and earnings and profits of the controlled foreign corporation for United States tax purposes.

\*\*\*\*\*

Par. 8. Section 1.904(b)-1 is revised to read as follows:

*§1.904(b)-1 Special rules for capital gains and losses.*

(a) *Capital amounts included in taxable income from sources outside the United States—*(1) *Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States—*(i) *In general.* Except as otherwise provided in this section, for purposes of section 904 and this section, taxable income from sources outside the United States (in all of the taxpayer's separate categories in the aggregate) shall include capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) only to the extent of capital gain net income from all sources. Similarly, except as otherwise provided in this section, for purposes of section 904 and this section, net capital gain from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) shall not exceed net capital gain from all sources.

(ii) *Allocation of reduction among multiple separate categories or rate groups.* If capital gain net income (or net capital gain) from sources outside the United States exceeds capital gain net income (or net capital gain), and the taxpayer has capital gain net income (or net capital gain) from sources outside the United States in two or more separate categories or in two or more rate groups, such excess must be



apportioned on a *pro rata* basis as a reduction to each such separate category, and then within each separate category, on a *pro rata* basis among rate groups. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of the capital gain net income (or net capital gain) from sources outside the United States in each separate category, or in each rate group within a separate category.

(2) *Capital losses from sources outside the United States in the same separate category.* Except as otherwise provided in paragraph (d) of this section, taxable income from sources outside the United States in each separate category shall be reduced by any capital loss that is allocable or apportionable to sources outside the United States in such separate category to the extent such loss is allowable in determining taxable income for the taxable year (taking into account losses allowable under section 1211(b)).

(3) *Exclusivity of rules; no reduction by reason of net capital losses from sources outside the United States in a different separate category.* Capital gains from sources outside the United States in any separate category shall be limited by reason of section 904(b)(2)(A) and the comparable limitation of section 904(b)(2)(B)(i) only to the extent provided in paragraph (a)(1) of this section (relating to limitation on capital gain from sources outside the United States when taxpayer has net capital losses from sources within the United States) and paragraph (a)(2) of this section (relating to capital losses from sources outside the United States in the same separate category).

(4) *Examples.* The following examples illustrate the application of this paragraph (a). The examples are as follows:

*Example 1.* Taxpayer A, a corporation, has a general limitation category capital loss of \$3,000 from sources outside the United States, a passive category capital gain of \$3,000 from sources outside the United States, and a capital loss of \$2,000 from sources within the United States. A has no capital gain net income from sources outside the United States (in the aggregate, from all separate categories), because the \$3,000 passive capital gain less the \$3,000 general limitation capital loss yields a net of zero. From all sources, A also has no capital gain net income. (The resulting \$2,000 net capital loss is not currently allowable under section 1211(a) because A is a corporation.) Because A's capital gain net income from sources outside the United States does not exceed A's capital gain net income from all sources, paragraph (a)(1) of this section does not

require any reduction of A's passive category capital gain.

*Example 2.* Taxpayer B, a corporation, has \$500 of capital gain net income from sources outside the United States, of which \$300 is in the general limitation category and \$200 is in the passive category. B's capital gain net income from sources outside the United States is \$500 (\$300 + \$200). Because B also incurs a capital loss of \$100 from sources within the United States, B's capital gain net income (from all sources) is \$400 (\$300 + \$200 - \$100). Pursuant to paragraph (a)(1)(B) of this section, the \$100 excess of capital gain net income from sources outside the United States over capital gain net income from all sources (\$500 - \$400) must be apportioned, as a reduction, three-fifths (\$300/\$500 of \$100, or \$60) to the general limitation category and two-fifths (\$200/\$500 of \$100, or \$40) to the passive category. Therefore, for purposes of section 904, the general limitation category includes \$240 (\$300 - \$60) of capital gain net income from sources outside the United States and the passive category includes \$160 (\$200 - \$40) of capital gain net income from sources outside the United States.

*Example 3.* Taxpayer C, a corporation, has a \$10,000 capital loss from sources outside the United States in the general limitation category, a \$4,000 capital gain from sources outside the United States in the passive category, and a \$2,000 capital gain from sources within the United States. C's capital gain net income from sources outside the United States is zero, since losses exceed gains. C's capital gain net income from all sources is also zero. C's capital gain net income from sources outside the United States does not exceed its capital gain net income from all sources, and therefore paragraph (a)(1) of this section does not require any reduction of C's passive category capital gain. For purposes of section 904, C's passive category includes \$4,000 of capital gain net income. C's general limitation category includes a capital loss of \$6,000 because only \$6,000 of capital loss is allowable as a deduction in the current year. The entire \$4,000 of capital loss in excess of the \$6,000 of capital loss that offsets capital gain in the taxable year is carried back or forward under section 1212(a), and none of such \$4,000 is taken into account under section 904(a) or (b) for the current taxable year.

(b) *Capital gain rate differential—(1) Application of adjustments only if capital gain rate differential exists.* Section 904(b)(2)(B) and paragraphs (c) and (d) of this section apply only for taxable years in which the taxpayer has a capital gain rate differential.

(2) *Determination of whether capital gain rate differential exists.* For purposes of section 904(b) and this section, a capital gain rate differential is considered to exist for the taxable year only if the taxpayer has a net capital gain for the taxable year and—

(i) In the case of a taxpayer other than a corporation, tax is imposed at a reduced rate under section 1(h) for the taxable year; or

(ii) In the case of a corporation, tax is imposed under section 1201(a) on the taxpayer at a rate less than any rate of tax imposed on the taxpayer by section 11, 511, or 831(a) or (b), whichever applies (determined without regard to the last sentence of section 11(b)(1)), for the taxable year.

(c) *Rate differential adjustment of capital gains—(1) Rate differential adjustment of capital gains in foreign source taxable income.* In determining taxable income from sources outside the United States for purposes of section 904 and this section, capital gain net income from sources outside the United States in each separate category, after any reduction pursuant to paragraph (a) of this section, shall be reduced by the sum of the rate differential portions (as defined in section 904(b)(3)(E)) of each rate group of net capital gain from sources outside the United States in such separate category.

(2) *Rate differential adjustment of capital gains in entire taxable income.* For purposes of section 904 and this section, the entire taxable income shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income reduced by the sum of the rate differential portions (as defined in section 904(b)(3)(E)) of each rate group of net capital gain.

(d) *Rate differential adjustment of capital losses from sources outside the United States—(1) In general.* In determining taxable income from sources outside the United States for purposes of section 904 and this section, any net capital loss from sources outside the United States included in a separate category pursuant to paragraph (a) of this section shall be reduced by the sum of the rate differential portion of the net capital gains (from the same rate group in other separate categories, from other rate groups in the same or other separate categories, or from sources within the United States) that are offset by such net capital loss in determining the taxpayer's entire taxable income.

(2) *Determination of which net capital gains are offset by net capital losses from sources outside the United States.* For purposes of paragraph (d)(1) of this section, in order to determine which net capital gains (from any rate group) are offset by net capital losses from sources outside the United States, the following rules shall apply in the following order:



(i) Capital losses from sources outside the United States shall first be netted against capital gains from sources outside the United States in the same rate group and the same separate category as the foreign source capital losses.

(ii) Net capital losses from each rate group from sources outside the United States shall be netted against net capital gains from sources outside the United States from the same rate group in other separate categories, ratably to the extent that net capital gains and losses in a particular rate group occur in two or more separate categories.

(iii) Capital losses from sources within the United States shall be netted against capital gains from sources within the United States in the same rate group.

(iv) The net foreign capital losses from each rate group, as determined under paragraph (d)(2)(ii) of this section, shall be netted against the taxpayer's remaining net capital gains from sources within and outside the United States in the following order, and without regard to any net capital losses, from any rate group, from sources within the United States—

(A) First against net capital gains from sources within the United States in the same rate group;

(B) Next, against net capital gains in other rate groups, in the order in which capital losses offset capital gains for purposes of determining the taxpayer's taxable income and without regard to whether such net capital gains derive from sources within or outside the United States, as follows:

(1) A short-term capital loss (including any short-term capital loss carryover) is used first to offset short-term capital gain otherwise taxable at ordinary income rates. Any remaining net short-term capital loss is used first to offset any net long-term gain in the 28 percent rate group, then to offset net long-term gain in the 25 percent rate group, and finally to offset net long-term gain in the 20 percent rate group.

(2) A net capital loss in the 28 percent rate group is used first to offset net capital gain in the 25 percent rate group, and then to offset net capital gain in the 20 percent rate group.

(3) A net capital loss in the 20 percent rate group is used first to offset net capital gain in the 28 percent rate group, and then

to offset net capital gain in the 25 percent rate group.

(v) The net capital losses from sources outside the United States in any rate group, to the extent netted against net capital gains in any other separate category under paragraph (d)(2)(ii) of this section or against net capital gains in any other rate group under paragraph (d)(2)(iv) of this section, shall be treated as coming *pro rata* from each separate category that contains net capital losses from sources outside the United States in that rate group. For example, assume that the taxpayer has \$20 of net capital losses in the 20 percent rate group in the passive category and \$40 of net capital losses in the 20 percent rate group in the general limitation category, both from sources outside the United States. Further assume that \$50 of the total \$60 net capital losses from sources outside the United States are netted against net capital gains in the 28 percent rate group (from other separate categories or from sources within the United States). One-third of the \$50 of such capital losses would be treated as coming from the passive category, and two-thirds of such \$50 would be treated as coming from the general limitation category.

(vi) The determination of which capital gains are offset by capital losses from sources outside the United States under this paragraph is made solely in order to determine the appropriate rate-differential-based adjustments to such capital losses under this section and section 904(b), and does not change the source, allocation, or separate category of any such capital gain or loss for purposes of computing taxable income from sources within or outside the United States or for any other purpose.

(e) *Definitions.* For purposes of section 904(b) and this section, the following definitions apply:

(1) *Alternative tax rate.* The term *alternative tax rate* means, with respect to any rate group, the rate applicable to that rate group under section 1(h) (for taxpayers other than corporations) or 1201(a) (for corporations). For example, the alternative tax rate for unrecaptured section 1250 gain is 25 percent.

(2) *Capital gain net income.* The term *capital gain net income* means the excess of the gains from the sales or exchanges of capital assets over the losses from such

sales or exchanges. Such term shall include net section 1231 gain, but shall not include gains or losses from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining capital gain net income, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(3) *Net capital gain.* The term *net capital gain* means the excess of the net long-term capital gain (including net section 1231 gain) for the taxable year over the net short-term capital loss for such year, but shall not include gains or losses from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining net capital gain, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(4) *Rate group.* For purposes of this section—

(i) *Capital gains.* With respect to capital gains, the term *rate group* means the amounts subject to a particular rate of tax under section 1(h). For example, the 20 percent rate group of capital gain net income from sources outside the United States consists of the capital gain net income from sources outside the United States that is subject to tax at a rate of 20 percent under section 1(h).

(ii) *Capital losses.* With respect to capital losses, the rate group shall be determined as if the sale or exchange that produced the capital loss had instead produced a capital gain. For example, if the sale of an asset held for more than one year yields a capital loss, but any gain generated by the sale would have been subject to tax at a rate of 20 percent under section 1(h), the capital loss is allocated to the 20 percent rate group for purposes of this section.

(5) *Terms used in sections 1(h), 904(b) or 1222.* For purposes of this section, any term used in this section and also used in section 1(h), section 904(b) or section 1222 shall have the same meaning given such term by section 1(h), 904(b) or 1222, respectively, except as otherwise provided in this section.

(f) *Examples.* The following examples illustrate the provisions of this section. In

these examples, the adjustment for the rate differential portion is shown as a fraction, the numerator of which is the alternative tax rate percentage and the denominator of which is 39.6 percent (the current highest applicable tax rate for individuals under section 1). All of the examples assume that all capital gains and losses are long-term capital gains and losses. (Therefore, in these examples, capital gain net income equals net capital gain, and for convenience both are referred to in the examples as net capital

gain in calculating the rate differential adjustments). In addition, all dollar amounts in the examples are abbreviated from amounts in the thousands (*e.g.*, \$50 represents \$50,000). The examples are as follows:

*Example 1.* (i) A, an individual, has foreign source items only in the passive category for the taxable year. A has \$1,000 of capital gains from sources outside the United States, which would be taxed at a rate of 20 percent under section 1(h). A has \$700 of capital losses from sources outside the United States, which resulted from the sale of capital assets held for more than one year. If the sale

had resulted in gain rather than loss, the gain would have been taxed at a rate of 20 percent under section 1(h). For the same taxable year, A has \$800 of capital gains from sources within the United States that are taxed at a rate of 28 percent under section 1(h). A also has \$100 of capital losses from sources within the United States. If the sale or exchange generating such capital losses had instead yielded a capital gain, such gain would have been subject to tax at a rate of 20 percent under section 1(h). A also has \$500 of ordinary income from sources within the United States.

(ii) A's items of ordinary income, capital gain and capital loss for the taxable year are summarized in the following table:

	U.S. source	foreign source: passive
<b>20% rate group</b>	(\$100)	\$1,000 (\$700)
<b>25% rate group</b>		
<b>28% rate group</b>	\$800	
<b>ordinary income</b>	\$500	

(iii) A's capital gain net income from sources outside the United States (\$300) does not exceed A's capital gain net income from all sources (\$1,000). Therefore, paragraph (a)(1) of this section does not require any reduction of A's capital gain net income in the passive category.

(iv) In computing A's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, capital gains and losses from sources outside the United States are netted within rate groups and within separate categories. See paragraphs (a)(2), (c)(1), and (d)(1) of this sec-

tion. The \$1,000 of capital gain less the \$700 of capital loss yields \$300 of net capital gain in the 20 percent rate group in the passive category. A must adjust the resulting net capital gain in the passive category as required under section 904(b)(2)(B)(i) and paragraph (c)(1) of this section, using 20 percent as the alternative tax rate, as follows:  $\$300(20\%/39.6\%)$ .

(v) In computing A's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, A must combine the \$300 net capital gain from sources outside the United States and the \$100 net capital loss from sources within the

United States in the same rate group (20 percent). A must adjust the resulting \$200 ( $\$300 - \$100$ ) of net capital gain in the 20 percent rate group as required under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section, using 20 percent as the alternative tax rate, as follows:  $\$200(20\%/39.6\%)$ . A must also adjust the \$800 of net capital gain in the 28 percent rate group, using 28 percent as the alternative tax rate, as follows:  $\$800(28\%/39.6\%)$ .

(vi) A's passive category foreign tax credit limitation is computed as follows:

$$\frac{\$300 (20\%/39.6\%)}{\$500 + \$200 (20\%/39.6\%) + \$800 (28\%/39.6\%)}$$

*Example 2.* (i) X, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	general	foreign source: passive
<b>20% rate group</b>	\$300	(\$500)	\$100
<b>25% rate group</b>	\$200		
<b>28% rate group</b>	\$500	(\$300)	
<b>ordinary income</b>	\$1,000	\$500	\$500

(ii) X's capital gain net income from sources outside the United States in the aggregate (zero, since losses exceed gains) does not exceed X's capital gain net income from all sources (\$300). Therefore, paragraph (a)(1) of this section does not require any reduction of X's capital gain net income in the passive category.

(iii) In computing X's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation cate-

gories, X must adjust capital gain net income and net capital losses as provided in section 904(b)(2)(B)(i) and (iii) and paragraphs (c)(1) and (d)(1) of this section.

(A) First, capital gains and losses from sources outside the United States are netted within rate groups and within separate categories. There are no such amounts to be netted in this case.

(B) Because X has net capital losses in the general limitation category, under paragraph (d)(2)(ii) of this section X's net capital losses from sources out-

side the United States in each rate group are netted against net capital gains from sources outside the United States in other separate categories in the same rate group. Thus, \$100 of the \$500 net capital loss in the 20 percent rate group in the general limitation category offsets \$100 of net capital gain in the 20 percent rate group in the passive category. The \$100 net capital gain remains in the passive category and is adjusted under paragraph (c)(1) of this section as follows:  $\$100(20\%/39.6\%)$ . The \$100 net capital loss remains in the general limitation category.

ry and is adjusted under paragraph (d)(1) of this section as follows: \$100 (20%/39.6%).

(C) Next, under paragraph (d)(2)(iv)(A) of this section, X's net capital losses from sources outside the United States in any rate group and in any separate category are netted against net capital gains in the same rate group from sources within the United States. Thus, \$300 of the \$500 net capital loss in the 20 percent rate group in the general limitation category offsets \$300 of net capital gain in the 20 percent rate group from sources within the United States. The \$300 of net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: \$300 (20%/39.6%). Similarly, the \$300 of net capital loss in the 28 percent rate group in the general limitation category offsets \$300 of net capital gain in the 28 percent rate group from sources within the United States. The

\$300 net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: \$300(28%/39.6%).

(D) Next, under paragraph (d)(2)(iv)(B) of this section, the remaining net capital losses in a rate group are netted against net capital gains from other rate groups from sources within and outside the United States. The remaining \$100 of the \$500 net capital loss in the 20 percent rate group in the general limitation category offsets \$100 of the remaining net capital gain in the 28 percent rate group from sources within the United States. The \$100 of net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: \$100 (28%/39.6%).

(iv) In computing X's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, X must adjust capital gain

net income by netting all of X's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate category, under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section. X must also include foreign source ordinary income in the numerators, and worldwide ordinary income in the denominator, of the foreign tax credit limitation fractions. The denominator of X's foreign tax credit limitation fractions reflects \$2,000 of worldwide ordinary income, \$100 of U.S.-source net capital gain taxed at the 28% rate and adjusted as follows: \$100 (28%/39.6%), and \$200 of U.S.-source net capital gain taxed at the 25% rate and adjusted as follows: \$200 (25%/39.6%).

(v) X's general limitation foreign tax credit limitation is computed as follows:

$$\frac{\$500 - \$100 (20\%/39.6\%) - \$300 (20\%/39.6\%) - \$300 (28\%/39.6\%) - \$100 (28\%/39.6\%)}{\$1,000 + \$500 + \$500 + \$100 (28\%/39.6\%) + \$200 (25\%/39.6\%)}$$

(vi) X's passive category foreign tax credit limitation is computed as follows:

$$\frac{\$500 + \$100 (20\%/39.6\%)}{\$1,000 + \$500 + \$500 + \$100 (28\%/39.6\%) + \$200 (25\%/39.6\%)}$$

*Example 3.* (i) Y, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	general	foreign source: passive
<b>20% rate group</b>	\$300	(\$720)	\$80
<b>25% rate group</b>	\$200		
<b>28% rate group</b>	\$500	(\$150)	50
<b>ordinary income</b>	\$1,000	\$1,000	\$500

(ii) Y's capital gain net income from sources outside the United States (zero, since losses exceed gains) does not exceed Y's capital gain net income from all sources (\$100). Therefore, paragraph (a)(1) of this section does not require any adjustment.

(iii) In computing Y's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, Y must adjust capital gain net income and net capital losses as provided in section 904(b)(2)(B)(i) and (iii) and paragraphs (c)(1) and (d)(1) of this section. Since Y has no capital gain net income in any separate category, the only adjustments are those required under section 904(b)(2)(B)(iii) and paragraph (d)(1) of this section.

(A) Under paragraph (d)(2)(ii) of this section, \$50 of Y's \$150 net capital loss in the 28 percent rate group in the general limitation category offsets \$50 of net capital gain in the 28 percent rate group in the passive category. The \$50 of net capital loss remains in the general limitation category and is adjusted as follows: \$50 (28%/39.6%). The \$50 of net capital gain remains in the passive category and is adjusted as follows: \$50 (28%/39.6%).

(B) Under paragraph (d)(2)(iv)(A) of this section, the remaining \$100 of net capital loss in the 28 percent rate group in the general limitation category

offsets \$100 of net capital gain in the 28 percent rate group from sources within the United States. The \$100 of net capital loss remains in the general limitation category and is adjusted as follows: \$100 (28%/39.6%).

(C) Under paragraph (d)(2)(iv)(A) of this section, the \$300 of net capital gain in the 20 percent rate group from sources within the United States is reduced proportionately by the net capital losses in the 20 percent rate group in the passive and general limitation categories. The proportionate amount of the \$720 net capital loss remains in the general limitation category, adjusted as follows: \$300 (\$720/\$800) (20%/39.6%). The proportionate amount of the \$80 net capital loss remains in the passive category, adjusted as follows: \$300 (\$80/\$800) (20%/39.6%).

(D) Of the remaining \$500 of net capital loss in the 20 percent rate group (in the general limitation and passive categories), \$400 offsets the remaining \$400 of net capital gain in the 28 percent rate group from sources within the United States under paragraph (d)(2)(iv)(B)(3) of this section. The proportionate amount of the \$720 net capital loss remains in the general limitation category, adjusted as follows: \$400 (\$720/\$800) (28%/39.6%). The proportionate amount of the \$80 net capital loss remains in the passive category, adjusted as follows: \$400 (\$80/\$800) (28%/39.6%).

(E) Under paragraph (d)(2)(iv)(B)(3) of this section, the remaining \$100 of net capital loss in the 20 percent rate group (in the general limitation and passive limitation categories) offsets \$100 of net capital gain in the 25 percent rate group from sources within the United States. The proportionate amount of the \$720 net capital loss remains in the general limitation category, adjusted as follows: \$100 (\$720/\$800) (25%/39.6%). The proportionate amount of the \$80 net capital loss remains in the passive category, adjusted as follows: \$100 (\$80/\$800) (25%/39.6%).

(iv) In computing Y's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, Y must adjust capital gain net income by netting all of Y's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate category, under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section. Y must also include foreign source ordinary income in the numerators, and worldwide ordinary income in the denominator, of the foreign tax credit limitation fractions. The denominator of Y's foreign tax credit limitation fractions reflects \$2,500 of worldwide ordinary income and \$100 of U.S.-source net capital gain taxed at the 25% rate and adjusted as follows: \$100 (25%/39.6%).

(v) Y's general limitation foreign tax credit limitation is computed as follows:

$\$1,000 - \$50 (28\%/39.6\%) - \$100 (28\%/39.6\%) - \$300 (\$720/\$800) (20\%/39.6\%) - \$400 (\$720/\$800) (28\%/39.6\%) - \$100 (\$720/\$800) (25\%/39.6\%)$

$\$1,000 + \$1,000 + \$500 + \$100 (25\%/39.6\%)$

(vi) Y's passive category foreign tax credit limitation is computed as follows:

$\$500 + \$50 (28\%/39.6\%) - \$300 (\$80/\$800) (20\%/39.6\%) - \$400 (\$80/\$800) (28\%/39.6\%) - \$100 (\$80/\$800) (25\%/39.6\%)$

$\$1,000 + \$1,000 + \$500 + \$100 (2.5\%/39.6\%)$

(g) *Coordination with overall foreign loss recapture rules.* Section 904(b) and this section shall apply before the provisions of section 904(f). Therefore, the amount of a taxpayer's separate limitation income or loss in each separate category, the amount of overall foreign loss, and the amount of any additions to or recapture of separate limitation loss or overall foreign loss accounts pursuant to section 904(f) shall be determined after applying section 904(b) and this section to adjust capital gains and losses in each separate category.

(h) *Effective date.* This section shall apply to taxable years beginning after the date this regulation is published in the **Federal Register** as a final regulation.

Par. 9. Section 1.904(b)-2 is revised to read as follows:

*§1.904(b)-2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.*

(a) *Application of section 904(b)(2)(B) adjustments.* Section 904(b)(2)(B) shall apply for purposes of determining the alternative minimum tax foreign tax credit under section 59 (regardless of whether or not the taxpayer has made an election under section 59(a)(4)).

(b) *Use of alternative minimum tax rates—(1) Taxpayers other than corporations.* In the case of a taxpayer other than a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59—

(i) Section 904(b)(3)(D)(i) shall be applied by substituting “section 55(b)(3)” for “subsection (h) of section 1”;

(ii) Section 904(b)(3)(E)(ii)(I) shall be applied by substituting “section 55(b)(1)(A)(i)” for “subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies)”; and

(iii) Section 904(b)(3)(E)(iii)(I) shall be applied by substituting “the alternative rate of tax determined under section

55(b)(3)” for “the alternative rate of tax determined under section 1(h)”.

(2) *Corporate taxpayers.* In the case of a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59, section 904(b)(3)(E)(ii)(I) shall be applied by substituting “section 55(b)(1)(B)” for “section 11(b)”.

(c) *Effective date.* This section shall apply to taxable years beginning after the date this section is published as a final regulation in the **Federal Register**.

#### **§§ 1.904(b)-3 and 1.904(b)-4 [Removed]**

Par. 10. Sections 1.904(b)-3 and 1.904(b)-4 are removed.

Par. 11. Section 1.904(j)-1 is added to read as follows:

*§1.904(j)-1 Certain individuals exempt from foreign tax credit limitation.*

(a) *Election available only if all foreign taxes are creditable foreign taxes.* A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

(b) *Coordination with carryover rules—(1) No carryovers to or from election year.* If the taxpayer elects to apply section 904(j) for any taxable year, then no taxes paid or accrued by the taxpayer during such taxable year may be deemed paid or accrued under section 904(c) in any other taxable year, and no taxes paid or accrued in any other taxable year may be deemed paid or accrued under section 904(c) in such taxable year.

(2) *Carryovers to and from other years determined without regard to election years.* The amount of the foreign taxes paid or accrued, and the amount of the foreign source taxable income, in any year

for which the taxpayer elects to apply section 904(j) shall not be taken into account in determining the amount of any carryover to or from any other taxable year. However, an election to apply section 904(j) to any year does not extend the number of taxable years to which unused foreign taxes may be carried under section 904(c) and §1.904-2(b). Therefore, in determining the number of such carryover years, the taxpayer must take into account years to which a section 904(j) election applies.

(3) *Determination of amount of creditable foreign taxes.* Otherwise allowable carryovers of foreign tax credits from other taxable years shall not be taken into account in determining whether the amount of creditable foreign taxes paid or accrued by an individual during a taxable year exceeds \$300 (\$600 in the case of a joint return) for purposes of section 904(j)(2)(B).

(c) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* In 2001, X, a single individual using the cash basis method of accounting for income and foreign tax credits, pays \$100 of foreign taxes with respect to general limitation income that was earned and included in income for United States tax purposes in 2000. The foreign taxes would be creditable under section 901 but are not shown on a payee statement furnished to X. X's only income for 2001 from sources outside the United States is qualified passive income, with respect to which X pays \$200 of creditable foreign taxes shown on a payee statement. X may not elect to apply section 904(j) for 2001 because some of X's foreign taxes are not creditable foreign taxes within the meaning of section 904(j)(3)(B).

*Example 2.* (i) In 2002, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of \$250 attributable to passive income. Under section 904(c), A may also carry forward to 2002 \$100 of unused foreign taxes paid in 1998 with respect to passive income, \$300 of unused foreign taxes paid in 1998 with respect to general limitation income, \$400 of unused foreign taxes paid in 1999 with respect to passive income, and \$200 of unused foreign taxes paid in 1999 with respect to general limitation income. In 2002, A's only foreign source



income is passive income described in section 904(j)(3)(A)(i), and this income is reported to A on a payee statement (within the meaning of section 6724(d)(2)). If A elects to apply section 904(j) for the 2002 taxable year, the unused foreign taxes paid in 1998 and 1999 are not deemed paid in 2002, and A, therefore, cannot claim a foreign tax credit for those taxes in 2002.

(ii) In 2003, A again is eligible for and elects the application of section 904(j). The carryforwards from 1998 expire in 2003. The carryforward period established under section 904(c) is not extended by A's election under section 904(j). In 2004, A does not elect the application of section 904(j). The \$600 of unused foreign taxes paid in 1999 on passive and general limitation income are deemed paid in 2004, under section 904(c), without any adjustment for any portion of those taxes that might have been used as a foreign tax credit in 2002 or 2003 if section 904(j) had not prevented A from carrying over taxes to those years.

(d) *Effective date.* Section 1.904(j)-1 applies to taxable years beginning after December 31, 1997.

Par. 12. Section 1.954-2 is amended by:

1. Revising paragraph (b)(2)(iv),  
*Example 2.*
2. Removing paragraph (b)(2)(iv),  
*Example 3.*

The revision reads as follows:

*§1.954-2 Foreign personal holding company income.*

\* \* \* \* \*

- (b) \* \* \*  
(2) \* \* \*  
(iv) \* \* \*

*Example 2.* (i) DS, a domestic corporation, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of §1.954-3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 is not manufactured in the United States under §1.927(a)-1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

\* \* \* \* \*

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

(Filed by the Office of the Federal Register on December 29, 2000, 8:45 a.m., and published in the

issue of the Federal Register for January 3, 2001, 66 F.R. 319)

## Notice of Proposed Rulemaking and Notice of Public Hearing

### Determination of Basis of Partner's Interest; Special Rules

#### REG-106702-00

AGENCY: Internal Revenue Service  
(IRS), Treasury.

ACTION: Notice of proposed rulemaking  
and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to special rules on determination of basis of partner's interest under section 705 of the Internal Revenue Code. The proposed regulations are necessary to coordinate sections 705 and 1032. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by April 12, 2001. Outlines of topics to be discussed at the public hearing scheduled for May 3, 2001, also must be received by April 12, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-106702-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106702-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at [http://www.irs.gov/tax\\_regs/reglist.html](http://www.irs.gov/tax_regs/reglist.html). The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Barbara MacMillan, (202) 622-3050; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION:

### Background

In Rev. Rul. 99-57 (1999-2 C.B. 678), the IRS issued guidance with respect to the tax consequences for a partnership and a corporate partner where the corporate partner contributes its own stock to the partnership, and the partnership later exchanges the stock with a third party in a taxable transaction. Under that ruling, section 1032 will protect a corporate partner from recognizing gain or loss (to the extent allocated to such partner) when the partnership exchanges stock of the corporate partner in a taxable transaction. The ruling also concludes that, under section 705, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

In situations where a corporation acquires an interest in a partnership that holds stock in that corporation, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock, it may be inconsistent with the intent of section 705 to increase the basis of the corporation's partnership interest by the full amount of the gain that is not recognized.

For instance, assume that a corporation (A) purchases a 50 percent interest in a partnership for \$100,000. The partnership's only asset is A stock with a basis of \$100,000 and a value of \$200,000. If the partnership had not made a section 754 election, then when the partnership disposes of the property for \$200,000, A would be allocated \$50,000 of gain. Under section 1032, the gain allocated to A would not be subject to tax. If A's basis in the partnership interest were increased to \$150,000 under section 705(a)(1), A would recognize a corresponding \$50,000 loss (or reduced gain) upon a subsequent sale of the partnership interest. In this situation, it would be inconsistent with the intent of section 705 to increase the basis of A's partnership interest for the gain that is not recognized. To do so would create a recognizable loss (or reduced gain) in a situation where no economic loss was incurred and no offsetting gain had previously been recognized.

Accordingly, in Notice 99-57 (1999-2 C.B. 692), the IRS announced that it intended to promulgate regulations under section 705 to address certain situations where a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquired the interest. The IRS announced that rules regarding tiered-entity structures also would be included in the regulations. The IRS requested comments as to the appropriate scope of the regulations regarding other situations where the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made an election under section 754. No formal comments were received.

### **Explanation of Provisions**

As discussed in Notice 99-57, these proposed regulations are being issued in order to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock.

The proposed regulations set forth a detailed statement of the purpose for these regulations which is consistent with the discussion in Notice 99-57. The proposed regulations then provide a specific rule implementing this purpose in situations where a corporate partner holds a direct interest in a partnership that owns stock of the corporate partner. This rule applies where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount

of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the taxable year in which the corporation acquired the interest, a section 754 election had been in effect.

The purpose of these proposed regulations cannot be avoided through the use of tiered partnerships or other arrangements. For example, the proposed regulations provide that if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of the proposed regulations. As stated above, the proposed regulations include a statement describing the purpose of these regulations which is intended to guide taxpayers in making basis adjustments in the tiered partnership context. In addition, the proposed regulations include two examples illustrating the basis adjustments that are required by the proposed regulations where a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships.

### **Proposed Effective Date**

The regulations shall apply to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C.

chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 3, 2001, beginning at 10 a.m., in room 6718 of the Internal Revenue Building. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of the preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 12, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal author of these proposed regulations is Matthew Lay of the Office

of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

\* \* \* \* \*

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.705–2 also issued under 26 U.S.C. 705. \* \* \*

Par. 2. Section 1.705–1 is amended by adding paragraph (a)(7) to read as follows:

*§1.705–1 Determination of basis of partner's interest.*

(a) \* \* \*

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a corporation directly or indirectly acquires an interest in a partnership that holds stock in that corporation, see §1.705–2.

\* \* \* \* \*

Par. 3. Section 1.705–2 is added to read as follows:

*§1.705–2 Basis adjustments coordinating sections 705 and 1032.*

(a) *Purpose.* This section is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). In the situation where a section 754 election was not in effect for the year in which the partner acquired its interest, however, a partner's inside basis and outside basis may not be equal. In this situation, gain or loss allocated to the partner upon disposition of

the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss) therefore generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

(b) *Single partnership—(1) Required adjustments.* This paragraph (b) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

(2) *Example.* The provisions of this paragraph (b) are illustrated by the following example:

*Example.* (i) A, B, and C form equal partnership PRS. Each partner contributes \$30,000 in exchange for its partnership interest. PRS has no liabilities. PRS purchases stock in corporation X for \$30,000, which appreciates in value to \$120,000. PRS also purchases inventory for \$60,000, which appreciates in value to \$150,000. A sells its interest in PRS to X for \$90,000 in a year for which an election under section 754 is not in effect. PRS later sells the X stock for \$150,000. PRS realizes a gain of \$120,000 on the sale of the X stock. X's share of the gain is \$40,000. Under section 1032, X does not recognize its share of the gain.

(ii) Normally, X would be entitled to a \$40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the X stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which X acquired its interest in PRS, X would have been entitled to a basis adjustment under section 743(b) of \$60,000 (the excess of X's basis for the transferred partnership interest over X's share of the adjusted basis to PRS of PRS's property). See §1.743–1(b). Under §1.755–1(b), the basis adjustment under section 743(b) would have been allocated \$30,000 to the X stock (the amount of the gain that would have been allocated to X from the hypothetical sale of the stock), and \$30,000 to the inventory (the amount of the gain that would have been allocated to X from the hypothetical sale of the inventory).

(iii) If a section 754 election had been in effect for the year in which X acquired its interest in PRS, the amount of gain that X would have recognized upon PRS's disposition of X stock (absent the application of section 1032) would be \$10,000 (X's share of PRS's gain from the stock sale, \$40,000, minus the amount of X's basis adjustment under section 743(b), \$30,000). See §1.743–1(j). Accordingly, the increase in the basis of X's interest in PRS is \$10,000.

(c) *Tiered partnerships and other arrangements—(1) Required adjustments.* The purpose of these proposed regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

(2) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

*Example 1. Acquisition of upper-tier partnership interest by corporation.* (i) A, B, and C form a partnership (UTP), with each partner contributing \$25,000. UTP and D form a partnership (LTP). UTP contributes \$75,000 in exchange for its interest in LTP, and D contributes \$25,000 in exchange for D's interest in LTP. Neither UTP nor LTP has any liabilities. LTP purchases stock in corporation E for \$100,000, which appreciates in value to \$1,000,000. C sells its interest in UTP to E for \$250,000 in a year for which an election under section 754 is not in effect for UTP or LTP. LTP later sells the E stock for \$2,000,000. LTP realizes a \$1,900,000 gain on the sale of the E stock. UTP's share of the gain is \$1,425,000, and E's share of the gain is \$475,000. Under section 1032, E does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the E stock (including E's share) were to increase the basis of UTP's interest in LTP, UTP's basis in such interest would be \$1,500,000 (\$75,000 + \$1,425,000). The fair market value of UTP's interest in LTP is \$1,500,000. Because UTP did not have a section 754 election in effect for the taxable year in which E acquired its interest in UTP, UTP's basis in the LTP interest does not reflect the purchase price paid by E for its interest. Increasing the basis of UTP's interest in LTP by the full amount of the gain that would be recognized (in the absence of section 1032) on the sale of the E stock preserves the conformity between UTP's inside basis and outside basis with respect to LTP (i.e., UTP's share of LTP's cash is equal to \$1,500,000, and UTP's basis in the LTP interest is \$1,500,000) and appropriately would cause UTP to recognize no gain or loss on the sale of UTP's interest in LTP immediately after the sale of the E stock. Accordingly, increasing the basis of UTP's interest in LTP by the entire amount of gain allocated to UTP (including E's share) from LTP's sale of the E stock is consistent with the purpose of this section. The \$1,425,000 of gain allocated by LTP to UTP will increase the adjusted basis of UTP's interest in LTP under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is \$1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be \$725,000 (\$250,000 + \$475,000) and the fair market value of such interest would be \$500,000, so that E would recognize a loss of \$225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of \$225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

(iv) The appropriate basis adjustment for E's interest in UTP upon the disposition of the E stock by LTP can be determined as the amount of gain that E would have recognized (in the absence of section 1032) upon the sale by LTP of the E stock if both UTP and LTP had made section 754 elections for the taxable year in which E acquired the interest in UTP. If section 754 elections had been in effect for UTP and LTP for the year in which E acquired E's interest in UTP, the following would occur. E would be entitled to a \$225,000 positive basis adjustment under section 743(b) with respect to the property of UTP. The entire basis adjustment would be allocated to UTP's only asset, its interest in LTP. In addition, the sale of C's interest in UTP would be treated as a deemed sale of E's share of UTP's interest in LTP for purposes of sections 754 and 743. The deemed selling price of E's share of UTP's interest in LTP would be \$250,000 (E's share of UTP's adjusted basis in LTP, \$25,000, plus E's basis adjustment under section 743(b) with respect to the assets of UTP, \$225,000). The deemed sale of E's share of UTP's interest in LTP would trigger a basis adjustment under section 743(b) of \$225,000 with respect to the assets of LTP (the excess of E's share of UTP's adjusted basis in LTP, including E's basis adjustment (\$225,000), \$250,000, over E's share of the adjusted basis of LTP's property, \$25,000). This \$225,000 adjustment by LTP would be allocated to LTP's only asset, the E stock, and would be segregated and allocated solely to E. The amount of LTP's gain from the sale of the E stock (before considering section 743(b)) would be \$1,900,000. E's share of this gain, \$475,000, would be offset in part by the \$225,000 basis adjustment under section 743(b), so that E would recognize gain equal to \$250,000 in the absence of section 1032.

(v) If the basis of E's interest in UTP were increased by \$250,000, the total basis of E's interest would equal \$500,000. This would conform to E's share of UTP's basis in the LTP interest (\$1,500,000  $\times$  1/3 = \$500,000) as well as E's indirect share of the cash held by LTP ((1/3  $\times$  3/4)  $\times$  \$2,000,000 = \$500,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by E on a subsequent disposition of E's interest in UTP and is consistent with the purpose of this section. Accordingly, under paragraph (c) of this section, of the \$475,000 gain allocated to E, only \$250,000 will apply to increase the adjusted basis of E in UTP under section 705(a)(1). E's adjusted basis in its UTP interest following the sale of the E stock is \$500,000.

*Example 2. Acquisition of lower-tier partnership interest by upper-tier partnership.* (i) A, B, and C form an equal partnership (UTP), with each partner contributing \$100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing \$30,000. LTP purchases stock in corporation B for \$90,000, which appreciates in value to \$900,000. LTP has no liabilities. UTP purchases D's interest in LTP for \$300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for \$900,000. UTP's share of the gain is \$270,000, and B's share of that gain is \$90,000. Under section 1032, B does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock

(including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be \$570,000 (\$300,000 + \$270,000), and the fair market value of such interest would be \$300,000, so that B would be allocated a loss of \$90,000 (( $\$570,000 - \$300,000$ )  $\times$  1/3) if UTP sold its interest in LTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a \$90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the \$90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000.

(iv) If the basis of UTP's interest in LTP were increased by \$180,000, the total basis of UTP's partnership interest would equal \$480,000. This would conform to the sum of UTP's share of the cash held by LTP (1/3  $\times$  \$900,000 = \$300,000) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP (\$90,000 + \$90,000 = \$180,000). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the \$270,000 gain allocated to UTP, only \$180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). UTP's adjusted basis in its LTP interest following the sale of the B stock is \$480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of \$190,000 (\$100,000 + \$90,000) and a value of \$100,000, so that B would recognize a loss of \$90,000 if B sold its interest in UTP immediately after LTP's disposition of the B



stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of \$90,000. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of UTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the \$90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000. The \$90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal \$100,000. This would conform to B's share of UTP's basis in the LTP interest  $((\$480,000 - \$180,000 \text{ (i.e., A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election)}) \times 1/3 = \$100,000$ ) as well as B's indirect share of the cash held by LTP  $((1/3 \times 1/3) \times \$900,000 = \$100,000)$ . Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under paragraph (c) of this section, of the \$90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is \$100,000.

(d) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

(Filed by the Office of the Federal Register on December 29, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 3, 2001, 66 F.R. 315)

## Notice of Proposed Rulemaking Removal of Federal Reserve Banks as Federal Depositaries REG-107176-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations which remove the Federal Reserve banks as authorized depositaries for Federal tax deposits. The regulations affect taxpayers who make Federal tax deposits using paper Federal Tax Deposit (FTD) coupons (Form 8109) at Federal Reserve banks.

DATES: Written or electronically generated comments and requests for a public hearing must be received by March 26, 2001.

ADDRESSES: Send submissions to: CC (REG-107176-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC (REG-107176-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brinton T. Warren, (202) 622-4940; concerning submissions of comments and requests for a public hearing, Treena Garrett of the Regulations Unit at (202) 622-7180 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION

### Background and Explanation of Provisions

This document contains proposed amendments to 26 CFR parts 1, 31, 35, 36, 40, 301, and 601 relating to Federal tax deposits under section 6302(c) of the Internal Revenue Code (Code). Section 6302(c) provides that the Secretary may authorize Federal Reserve banks, and incorporated banks, trust companies, domestic building and loan associations, or credit unions that are depositaries or financial agents of the United States, to receive any tax imposed under the internal revenue laws, in such manner, at such times, and under such conditions as the Secretary may prescribe. Pursuant to this authority, various regulations provide that Federal Reserve banks, as well as other authorized financial institutions, may receive certain Federal tax deposits.

In cooperation with the Treasury Department's Financial Management Service (FMS), the Federal Reserve System has been streamlining its Treasury Tax and Loan (TT&L) Operation to respond to the fact that the overwhelming majority of Federal Tax Deposits (FTDs) are now received electronically. The widespread adoption of electronic deposits by taxpayers is an important aspect of improving the efficiency, reliability, and cost-effectiveness of the Treasury Department's financial management. In general, compared to the universe of all tax deposits, the percentage of FTDs made with paper coupons has significantly declined. FTDs made with paper coupons at Federal Reserve banks now constitute only a tiny percentage of all tax deposits. For example, in Fiscal Year 1999, of the approximately 100 million Federal tax deposits, made by paper coupon and electronically, only about 270,000, or less than one half of one percent, were paper coupons presented at Federal Reserve banks. Additionally, the number of paper coupons presented at Federal Reserve banks has declined over twenty-five percent since 1997.

The Treasury Department has developed an array of other deposit options that are more convenient for taxpayers to use, and more economical to process, than deposits with Federal Reserve banks. For example, taxpayers may use their touch tone telephone or personal computer to make

deposits 24 hours a day through the Electronic Federal Tax Payment System (EFTPS). For those taxpayers who still prefer paper coupons over electronic deposits, there are now more than 10,000 financial institutions nationwide that are designated as TT&L depositories where taxpayers may make FTD deposits using paper coupons.

In response to the declining number of deposits being made with paper coupons at Federal Reserve banks, the Federal Reserve Bank of St. Louis was selected, effective May 1, 2000, to serve as the only Federal Reserve bank accepting FTDs. Even after this consolidation, however, it is no longer cost-effective for the Federal Reserve bank in St. Louis to process the small number of paper coupons it receives annually. Accordingly, these proposed regulations remove all Federal Reserve banks as depositories for Federal taxes. To mitigate any difficulties for those taxpayers who still do not wish to use the deposit alternatives discussed above, the Treasury Department has authorized a financial agent to receive and process FTD payments through the mail, thereby maintaining a mail-in alternative for taxpayers who do not have an account with an authorized financial institution and who do not wish to use EFTPS. The address for this mail-in alternative is Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, Missouri, 63197.

### Proposed Effective Date

The regulations, as proposed, apply to any deposits of Federal taxes made after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a signifi-

cant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### Drafting Information

The principal author of these regulations is Brinton T. Warren of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

## Proposed Amendments to the Regulations

Accordingly, and under the authority of 26 U.S.C. 7805 and 5 U.S.C. 301, 26 CFR parts 1, 31, 35, 36, 40, 301 and 601 are proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.6302–1 is amended by removing the fifth sentence in paragraph (b)(1).

Par. 3. Section 1.6302–2 is amended by removing the third sentence in paragraph (b)(1).

### PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 4. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 5. Section 31.6302–1 is amended by removing the fourth sentence in paragraph (i)(3).

Par. 6. Section 31.6302(c)–3 is amended by removing the third sentence in paragraph (b)(2).

### PARTS 1, 31, 35, 36, 40, 301, 601—[AMENDED]

Par. 7. In the list below, for each section indicated in the left column, remove the language in the middle column and add, if any, the language in the right column:

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.1461–1(a), effective January 1, 2001	a Federal reserve bank or	an
1.1502–5(a)(1)	commercial dispository or Federal Reserve Bank	financial institution
1.6151–1(d)(1)	Federal Reserve Banks or	-----
1.6302–1(b)(1) fourth sentence	214 or, at the election of the corporation, to a Federal Reserve bank	203

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.6302-1(b)(1)(as amended by paragraph 2) fifth sentence	the Federal Reserve bank or	-----
1.6302-2(a)(1)(i)	a Federal Reserve bank or	an
1.6302-2(a)(1)(ii)	a Federal Reserve bank or	an
1.6302-2(a)(1)(iv)	a Federal Reserve bank or	an
1.6302-2(b)(1) second sentence	214 or, at the election of the withholding agent, to a Federal Reserve bank	203
1.6302-2(b)(1)(as amended by paragraph 3) third sentence	the Federal Reserve bank or	-----
1.6302-3(a)	or with a Federal Reserve Bank	-----
31.6071(a)-1(a)(1)	or by a Federal Reserve bank	-----
31.6071(a)-1(c)	a Federal Reserve bank or by	-----
31.6151-1(b)	Federal Reserve banks and	-----
31.6302-1(c)(1)	a Federal Reserve bank or	an
31.6302-1(c)(2)(i)	a Federal Reserve bank or	an
31.6302-1(c)(3)	a Federal Reserve bank or	an
31.6302-1(i)(3)	214 or, at the election of the employer, to a Federal Reserve bank	203
31.6302-1(i)(5)	the Federal Reserve bank or	-----
31.6302(c)-2A(b)(1)(i)	with a Federal Reserve bank or	-----
31.6302(c)-2A(b)(3)	with a Federal Reserve bank or	-----
31.6302(c)-3(a)(1)(i)	with a Federal Reserve bank or	-----
31.6302(c)-3(a)(1)(ii)	with a Federal Reserve bank or	-----
31.6302(c)-3(a)(3)	with a Federal Reserve bank or	-----
31.6302(c)-3(b)(2) second sentence	214 or, at the election of the employer, to a Federal Reserve bank	203
31.6302(c)-3(b)(2) (as amended by paragraph 6) third sentence	the Federal Reserve bank or	-----
35.3405-1T(e-10)	a Federal Reserve Bank or	-----
36.3121(l)(10)-4	a Federal Reserve bank or	an
40.6302(c)-1(d)(1)	214) or to a Federal Reserve bank	203)
301.6302-1(a)	Federal Reserve banks and authorized commercial banks	authorized financial institutions
301.6302-1(b)(1)	Federal Reserve banks or authorized commercial banks	authorized financial institutions

<i>Section</i>	<i>Remove</i>	<i>Add</i>
301.6302-1(b)(2)	Federal Reserve banks or authorized commercial banks	authorized financial institutions
301.9100-5T(c)(3)	Federal Reserve banks and	-----
601.401(a)(5) heading	Federal Reserve banks and	-----
601.401(a)(5)(iii) first sentence	a Federal Reserve bank or	an
601.401(a)(5)(iii) second sentence	a Federal Reserve bank or	an
601.401(a)(5)(iv)	a Federal Reserve bank or a financial institution authorized in accordance with Treasury Department Circular No. 1079, revised, to accept remittances of these taxes for transmission to a Federal Reserve bank	an authorized financial institution

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

(Filed by the Office of the Federal Register on December 22, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 26, 2000, 65 F.R. 81453)

## Information Reporting for Payments of Qualified Tuition and Payments of Interest on Qualified Education Loans; Magnetic Media Filing Requirements for Information Returns; Public Hearing

### Announcement 2001-10

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of public hearing on proposed rulemaking.

SUMMARY: This document contains a notice of public hearing on proposed regulations relating to reporting for payments of qualified tuition and payments of interest on qualified education loans and magnetic filing requirements for information returns.

DATES: The public hearing is being held on Tuesday, February 13, 2001, at 10 a.m.

The IRS must receive outlines of the topics to be discussed at the hearing by January 23, 2001.

ADDRESSES: The public hearing is being held in the auditorium, Room 7218, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building.

Mail outlines to: Regulations Unit CC (REG-105316-98), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Hand deliver outlines Monday through Friday between the hours of 8 a.m. and 5 p.m. to: Regulations Unit CC (REG-105316-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Submit electronic outlines of oral comments directly to the IRS Internet site at:

[http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not a toll-free number).

### SUPPLEMENTARY INFORMATION:

The subject of the public hearing is proposed regulations (REG-105316-98, 2000-27 I.R.B. 98) that were published in the **Federal Register** on Friday, June 16, 2000 (65 F.R. 37728).

The rules of §601.601(a)(3) apply to the hearing.

Persons who have submitted written comments and wish to present oral comments at the hearing, must submit an outline of the topics to be discussed and the amount of time to be devoted to each topic (signed original and eight (8) copies) by January 23, 2001.

A period of 10 minutes is allotted to each person for presenting oral comments.

After the deadline for receiving outlines has passed, the IRS will prepare an agenda containing the schedule of speakers. Copies of the agenda will be made available, free of charge, at the hearing.

Because of access restrictions, the IRS will not admit visitors beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this document.



Cynthia E. Grigsby,  
*Chief, Regulations Unit,*  
*Office of Special Counsel*  
*(Modernization & Strategic Planning).*

(Filed by the Office of the Federal Register on December 19, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 20, 2000, 65 F.R. 79788)

**Guidance Under Section 355(e);  
Recognition of Gain on Certain  
Distributions of Stock or  
Securities in Connection With an  
Acquisition; Withdrawal of  
Proposed Rulemaking**

**Announcement 2001-11**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws the notice of proposed rulemaking relat-

ing to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition that was published in the **Federal Register** on August 24, 1999. The withdrawal is in response to written comments received and oral comments presented at a public hearing.

EFFECTIVE DATE: These regulations are effective January 2, 2001.

FOR FURTHER INFORMATION CONTACT: Brendan O'Hara, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

On August 24, 1999, the IRS issued proposed regulations (REG-116733-98, 1999-2 C.B. 392) in the **Federal Register** (64 F.R. 46155) under section 355(e), relating to the recognition of gain on certain distributions of stock or securities in connection with an acquisition of stock of the distributing corporation or of stock of the

corporation whose stock is distributed. In response to written comments received and comments presented at a public hearing, these proposed regulations are being withdrawn. New proposed regulations (REG-107566-00) covering the same matters as the withdrawn proposed regulations were being issued in 2001-3 I.R.B. 346.

\* \* \* \* \*

**Withdrawal of Notice of Proposed  
Rulemaking**

Accordingly, under the authority of 26 U.S.C. 7805 and 26 U.S.C. 355(e)(5), the notice of proposed rulemaking (REG-116733-98) that was published in the **Federal Register** on August 24, 1999 (64 F.R. 46155) is withdrawn.

Robert E. Wenzel,  
*Deputy Commissioner*  
*of Internal Revenue.*

(Filed by the Office of the Federal Register on December 29, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2001, 66 F.R. 76)

## Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.

E.O.—Executive Order.  
ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign Corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.

PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statements of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2000–27 through 2000–52 is in Internal Revenue Bulletin 2001–1, dated January 2, 2001.

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